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Fiscal policy coordination in times of economic and financial crises

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**Declaration**

1 December 2013

I hereby declare that this thesis is entirely my own work, and that no part of it has been submitted for any other degree or qualification.

Charlotte Rommerskirchen

## **Abstract**

This thesis examines fiscal policy coordination in the EU during the Great Recession (2008-2010). For the first time since the Maastricht Treaty heralded the coordination of macroeconomic policies among EU Member States, public finances were collectively focused on stimulus policies. In sharp contrast to the preceding decade of consolidation and constraint, fiscal policy coordination during the Great Recession presents a novelty: a study in fiscal expansion. Drawing on Mancur Olson's *Logic of Collective Action*, this thesis uses a mixed-methods approach that combines the insights from over 40 in-depth interviews and econometric analyses. The central argument of this thesis is that the fiscal crisis responses of EU Member States were not coordinated. Yet despite this lack of coordination, free-riding was kept at bay. First, the overarching consensus on the need for counter-cyclical fiscal policies prevented growth free-riding (i.e. a situation of limited domestic stimulus and free-riding on other countries' expansive fiscal policies). Second, discipline imposed by financial market participants contributed to policy-makers' awareness of their limited room for fiscal manoeuvre, which meant that stability free-riding (i.e. stimulus policies that exceeded a country's fiscal space) did not occur. The first finding suggests the importance of shared policy ideas in achieving collective action; the second points to the role of financial markets in constraining public finances. Ultimately both, shared policy ideas and market discipline, can function as a substitute for strong institutional commitment to shape group oriented behaviour.

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## **List of Abbreviations and Acronyms**

BB	Budget Balance
BEPGs	Broad Economic Policy Guidelines
CACs	Collective Action Clauses
Ecofin	Council of Economic and Finance Ministers
DG Ecfm	Directorate General of Economic and Financial Affairs
EMU	Economic and Monetary Union
ECB	European Central Bank
ECJ	European Court of Justice
EERP	European Economic Recovery Plan
EFSM	European Financial Stabilisation Mechanism
EFSF	European Financial Stability Facility
EIB	European Investment Bank
EP	European Parliament
EEP	European Political Economy
ESM	European Stability Mechanism
EU	European Union
EDP	Excessive Deficit Procedure
EIP	Excessive Imbalances Procedure
FRSI	Fiscal Rule Strength Index
fQCA	Fuzzy Qualitative Comparative Analysis
GDP	Growth Domestic Product
ILO	International Labour Organization
IR	International Relations
IMF	International Monetary Fund
IPE	International Political Economy
LTRO	Long-Term Refinancing Operations
MAP	Mutual Assessment Process



MIP	Macroeconomic Imbalances Procedure
MTOs	Medium-Term Objectives
OECD	Organization of Economic Co-operation and Development
OMT	Outright Monetary Transactions
PBC	Political Business Cycle
PB	Primary Balance
PSB	Primary Structural Balances
PSI	Private Sector Involvement
SGP	Stability and Growth Pact
SB	Structural Balance
VRTF	Van Rompuy Task Force
QCA	Qualitative Comparative Analysis

## ***CHAPTER 1: INTRODUCTION***

### **Introduction**

‘The levers of government, the instruments of the European Union, the influence of intelligent coordination add up to a potent force to arrest the trend towards a deeper recession. [...] We sink or swim together’ (EERP 2008).

The preface of the European Economic Recovery Plan (EERP) emphasised the necessity for fiscal policy coordination during the economic and financial crises of 2008-2010. The plan sought to provide a framework for counter-cyclical policies as European Union (EU) governments stepped in with a range of national fiscal stimulus measures, amounting to a total of 1.9 per cent of EU Gross Domestic Product (GDP) (European Commission 2010)<sup>1</sup>, in order to mitigate the global economic fall-out. For the first time since the Maastricht Treaty in 1992 had heralded the coordination of macroeconomic policies among EU Member States, the ‘potent forces’ of public finances were collectively directed towards stimulus. In sharp contrast to the past decade of consolidation and constraint, fiscal policy coordination during the Great Recession<sup>2</sup> presents a novelty: a study in fiscal expansion.

This development has to be viewed against the backdrop of an economic crisis that, according to Eichengreen and O’Rourke (2009) was ‘every bit as big as the Great Depression shock of 1929–30’.<sup>3</sup> The World Bank (2010) estimates that the Great Recession has resulted in an increase in poverty of 64 million people globally. From the start of 2008 to the spring of 2009, the crisis knocked \$30 (US) trillion off the

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<sup>1</sup> Not counting off-balance sheet measures and the economic support provided by automatic fiscal stabilisers.

<sup>2</sup> For the purpose of this study, the temporal scope of the term Great Recession covers the years 2008-2010, see also below.

<sup>3</sup> However Romer (2009) does not agree with this juxtaposition and argues that the ‘current recession [...] pales in comparison with what our parents and grandparents experienced in the 1930s’.

value of global shares and \$11 trillion off the value of homes (*the Economist* 1.11.2009). At their worst, these losses amounted to around 75 per cent of annual world GDP. The EU economy has been hit particularly hard by the shockwaves of the financial and economic crisis; unemployment increased from an average of 7.1 per cent in 2008 to 10.5 per cent in 2012, GDP declined by almost 4 per cent in 2009 and growth rates remained below expectations five years after the collapse of the global financial system. When recession struck many national economies in the fall of 2008, policy-makers around the globe speedily abandoned the fiscal and monetary orthodoxies of economic policymaking that had been widely accepted since the 1980s (Armingeon 2012). The first step of many governments was to support ailing financial institutions with substantial bailout programmes. With regards monetary policy, the European Central Bank (ECB) and other national central banks have reduced interest rates to unprecedented lows and many central banks have engaged in 'unconventional' direct operations in financial markets to ease liquidity constraints. As the room for monetary easing shrank due to a lack of space for additional interest rate cuts and impaired monetary transmission channels, fiscal policy became a key tool for stimulating recovery. The fiscal cost of the economic and financial crisis is considerable; in the EU, debt increased from 59 per cent of GDP in 2007 to 83.3 per cent in 2012 (European Commission 2011), whilst budget balances deteriorated from an average deficit of 0.9 per cent of GDP to over 6.8 per cent (*ibid.*) between 2007 and 2009. Given the magnitude of discretionary spending, Skidelsky (2009) proclaimed the 'return of the master', referring to the Keynesian style policy-mix of providing tax rebates or subsidies for private spending and big increases in loan-financed public spending. Even Robert Lucas, high priest of Chicago economics, conceded that 'we are all Keynesians in the foxhole' (quoted in Skidelsky 2011: 4).

However the fiscal policy legacy of the Great Recession goes beyond the deterioration in public finances brought about by financial sector bailouts, falling tax revenues, the operation of automatic stabilisers and deliberate additional Keynesian-style expansion. Firstly, the events of 2008-2010 lead to a reconsideration of what

constitutes group oriented behaviour in the realm of fiscal policy coordination. As Member States turned to discretionary fiscal policy, the concern for coordination no longer focused on respecting existing deficit ceilings, but on providing sufficient stimulus spending. Free-riding refers to the absence of a contribution towards the provision of a public good by a group member who stands to benefit from the public good in question (see Chapter 2). The onset of the economic crisis redefined the scope of free-riding by considering both growth and stability as public goods<sup>4</sup>. The first (and predominantly, pre-crisis) type of free-riding, stability free-riding, addresses the hazard of ‘too much’ fiscal expansion relative to a given country’s room for fiscal manoeuvre and free-riding on other Member States’ sound fiscal policies. The second type consists of ‘too little’ fiscal expansion in response to the Great Recession and free-riding on the expansive fiscal policies of other Member States. This dissection of free-riding, with growth on the one hand and stability on the other, has outlasted the 2008-2010 period and is likely to establish itself as a reference point in EU macroeconomic policy coordination. Secondly, and related to the first point, the traditional consensus on the ‘sound money and finance paradigm’ has not survived the economic fallout unscathed. Faced with an incapacity to explain, let alone prevent, the European Sovereign Debt Crisis, policy-makers at the domestic and EU level are increasingly looking for more nuanced guidelines on macroeconomic management. The field of policy contestation is wide open and it remains to be seen whether we will witness the funeral or the resurrection of old policy paradigms. Yet it already appears in 2013 that, contrary to Blyth’s (2013: 21) dismay, austerity politics are *not* ‘perceived as the only possible response [...] in Europe’. Finally, amidst the on-going Sovereign Debt Crisis, policy-makers have implemented the most substantial overhaul of EU economic governance since the Maastricht Treaty, with the causal link running from the crises experience to reforms.

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<sup>4</sup> A public good is a good whose consumption cannot be limited to group members who contributed to its production but is available to all, also free-riding, group members (Olson 1965: 35).

By examining fiscal policy coordination during the 2008-2010 period, this thesis seeks to enrich our understanding of fiscal policy coordination in ‘hard times’ (Gourevitch 1986). Drawing on Mancur Olson’s *Logic of Collective Action* (1965), the focus will be on the determinants of group-oriented behaviour in the context of fiscal crisis responses. The central argument of this thesis is that the fiscal crisis responses of EU Member States were not coordinated. Yet despite this lack of coordination, I find no strong evidence for free-riding behaviour. On the one hand, the overarching consensus on the need for counter-cyclical fiscal policies prevented growth free-riding (i.e. stimulating ‘too little’). On the other hand, discipline imposed by financial market participants contributed to policy-makers’ awareness of their limited fiscal space which meant that by and large, stability free-riding (i.e. stimulating ‘too much’) was not an issue either. The first finding suggests the importance of shared policy ideas in achieving collective action, whilst the second points to the role of markets in constraining public finances. I argue that ultimately, both can function as a substitute for strong institutional commitment in order to shape group oriented behaviour.

This chapter is organised as follows: The central research question of the thesis will be discussed and the framework for the analysis of fiscal policy coordination during the Great Recession presented. The next section presents the central research question, before placing the study into context with a brief overview over the two crises that occurred during the 2008-2010 period. Consideration is then given to the broader literature of ‘crisis studies’ and I will place this thesis within this body of literature. The main aim of this section is to make the case for an in-depth study of EU fiscal policy coordination during the Great Recession. Subsequently the short history of fiscal policy coordination in the EU, beginning with the creation of the Stability and Growth Pact (SGP) in 1997 and ending with the agreement on the European Economic Recovery Plan in 2008, will be presented. This provides an important backdrop for the analysis, without which we would likely lose the significance of the divergence from the old regime in some aspects of fiscal policy

coordination when compared to the surprising continuity in other aspects. The chapter ends with an outline of the structure of the remainder of the thesis.

### **Research question**

This thesis explores fiscal policy coordination between 2008 and 2010, situated during two interrelated crises – the economic and financial crisis which erupted in the EU in 2008 and the European Sovereign Debt Crisis which began in late 2009. Thus the main dependent variables with which I am concerned are fiscal policy outcomes. As such, this thesis does not merely consider discretionary stimulus packages, but uses a broader set of fiscal policy variables in order to capture the full spectrum of fiscal responses to the crises. On the one hand, discretionary fiscal policy measures are notoriously difficult to quantify (see Chapter 4). On the other hand, I argue that ignoring seemingly ‘automatic’ fiscal policy outcomes fails to consider that automatic and discretionary fiscal policies are interrelated choices and may furthermore lead to an underestimation of the magnitude of any fiscal crisis response strategies. I thus consider four fiscal policy variables – the budget balance, the primary budget balance, the structural balance and the primary structural balance – as regressands in the quantitative models of Chapter 5 and 6. Supplemented with estimates of fiscal stimulus packages made by the European Commission, the ECB and international organisations such as the International Monetary Fund (IMF), these measurements allow for a consideration of national response strategies vis-à-vis the challenge of EU-wide fiscal stimulus coordination. My central research question is thus:

*What are the determinants of fiscal policy coordination in the EU during the Great Recession?*

In answering this question, this study makes use of Olson’s (1965) theory of collective action. According to Olson, the theory refers to a situation where a

collective good provides benefits and/or costs for more than one individual, hence requiring coordination of actions. This raises concerns over the issue of free-riding which, in the context of fiscal policy coordination during the Great Recession, refers to growth and stability free-riding. Applying and developing Olson's approach, I seek to explain the limits of fiscal policy coordination in times of crises. Olson (1965: 50) distinguishes between three kinds of groups, namely privileged, intermediate, and latent. The latter is characterised as suffering from chronic collective action failure. As a result, group latency is then inversely related to the probability of a public good being provided. However collective action failure in a latent group can be overcome by the provision of separate and selective incentives (*ibid.*). This thesis adopts a three-step testing design to systematically develop its three main hypotheses from Olson's theory of collective action. In a first step I examine whether, in terms of fiscal policy coordination, EU Member States can be characterised as forming a latent group. By specifically identifying the determinants of fiscal policy outcomes, I am able to draw inference on group latency. If group latency is found to be a problem, Olson suggests the need for incentives to motivate group members to contribute to the production of the collective good in question. Thus in the second step I examine the workings of different separate and selective incentives, identified through fiscal rules/fiscal policy agreements and market discipline and consider whether or not they mattered for public finances in times of crises. Weak incentives, in turn, would imply a high likelihood of free-riding behaviour/collective action failure. The third step of this thesis therefore considers the evidence in favour or against stability and growth free-riding during the Great Recession.

In the tradition of International Political Economy (IPE) and specifically European Political Economy (EPE), this thesis will consist of empirical social science research based on direct observations as the foundation or source of knowledge. Observable information found in quantitative analyses, along with interview material from key actors working on EU fiscal policy coordination, will be employed as the means of

answering questions and testing hypotheses. This study seeks to comprehensively answer the question of what drove fiscal policy and its coordination in times of financial and economic crises. Such an approach implies an appreciation of the values and benefits of interdisciplinary research, which the matter under consideration requires. In so doing, it will transcend the quantitative/qualitative distinction, guided by the methodological framework of the so-called mixed-methods approach. Cini and Bourne (2006: 7) remind us that the past 25 years of European integration scholarship should give reason for taking this ambition with a pinch of salt; the clarion call for interdisciplinary is most often mere window-dressing for studies that are in fact multidisciplinary. Avoidance of falling into this camp is part of the challenge embraced herein.

### **A tale of two crises**

In scrutinizing fiscal policy coordination during the 2008- 2010 period, this thesis spans both the economic and financial crisis erupting in 2008 and also the European Sovereign Debt Crisis that erupted in 2009. The analysis of this particular aspect of economic policy cooperation therefore considers a tale of two crises. A word on the temporal boundaries; setting start and end points for a series of events as complex as an economic and financial crisis with its various channels and different effects on Member States' economies is bound to present stylised facts. In the following discussion, the Great Recession is situated between the fall of Lehmann Brothers in the autumn of 2008 and the agreed end of the EERP in late 2010.

### **The economic and financial crisis**

European leaders were slow to grasp the scope of the financial crisis and to gauge the true rate of exposure of their banking sectors (Almunia 2008a). Their view was that the crisis was made in the USA, blaming it on 'irresponsible Anglo-Saxon Financial Capitalism' (Barber 2010) and believing that it would mainly be confined to its



geographical boundaries.<sup>5</sup> In the words of the former German vice Chancellor Peer Steinbrück (2008a) ‘there is no reason – and I do say this very intentionally – to doubt the stability of the German financial system. The German system of universal banking has been shown to be more robust and resistant than the American banking system’. It was only in mid-2008 when several financial institutions in the UK (Northern Rock), Belgium/the Netherlands (Fortis), Germany (Hypo Real Estate), Belgium/France/Luxembourg (Dexia), and Ireland (notably Anglo Irish Bank) had to be rescued by their respective governments, that the true scope of the crisis became clear. European financial institutions, inflicted with a severe shortage of capital and substantial asset write-downs, were not immune to the global financial turmoil and governments were jolted into action. As policy-makers implemented emergency bailout plans to prevent the banking sector from collapsing, the near simultaneous break down in demand in almost all of the EU's major trading partners further aggravated the shock to the real economy and the financial sector, pushing most of Europe’s economies into recession. Unsurprisingly, subsequent stimulus programmes, in addition to the working of automatic stabilisers, came at a high and immediate fiscal cost. Alongside the abrupt decline in economic activity and revenue losses caused by the recession, financial sector support programmes, automatic stabilisation and discretionary fiscal packages contributed to a rise in government deficits and debt in all EU countries as revenues collapsed. Countries, who prior to the Great Recession experienced the build up of large macroeconomic imbalances, experienced a more pronounced and protracted economic downturn. These imbalances worsened during the Great Recession as credit and housing booms evaporated (European Commission 2011). Moreover, crisis response measures also impacted on countries’ sovereign risk where bailouts had no immediate balance sheet implications and did not show up as rising debt or deficit burdens. The bulk of measures aimed at stabilising the financial sector consisted of so-called ‘contingent

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<sup>5</sup> The portrayal of the crisis as a crisis was however hardly accurate, as was the claim of European banks being more sound than their US counterparts (Carmassi *et al.* 2009). Furthermore, five years after the fall of Lehman Brothers it appears that overall US banks have had a ‘better crisis’ with ‘Europe’s banks [...] on their knees and Wall Street [...] resurgent’ (*the Economist* 11.05.2013).

liabilities'. These encompassed both obligations dependent on the occurrence of some uncertain future event such as government guarantees or non-performing loans, and also liabilities that stemmed from the operation of public corporations.

Contingent liabilities were used extensively in Ireland, the United Kingdom and Germany. For example, contingent liabilities taken on by the Irish government in 2008 amounted to EUR 350 billion and in the EU27 as a whole, the stock of contingent liabilities reached 10 per cent of GDP in 2008 and 2009 respectively (European Commission 2010). Given that the underlying weaknesses and interdependencies of the financial system remained inadequately addressed, these contingencies, although not impacting on the headline deficit and debt numbers, had implications for the sovereign risk evaluation of the Eurozone and to a lesser extent, EU Member states. Thus the financial and economic crisis of 2008-2009 not only fertilised, but in some instances even sowed the very seeds of the Sovereign Debt Crisis.

### **The European Sovereign Debt Crisis**

Just one year after marking a decade of existence, the Eurozone descended into the most serious crisis of its short history. In contrast to the economic fallout of the Great Recession that has proliferated across many Western economies, the Sovereign Debt Crisis is a markedly Eurozone phenomenon. That is to say, it is a homemade European banking crisis that reflects macroeconomic imbalances and consequently, the exposure of banks in numerous Member States to potential debt default (Schelkle 2011).<sup>6</sup> In similar fashion to the events of 2008, the European Sovereign Debt Crisis has been met with surprise by European policy-makers. At the end of 2008, the possibility of a full-blown Sovereign Debt Crisis was considerably underestimated (European Commission 2009). Through 2008 and 2009, European sovereign debt

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<sup>6</sup> It follows that the very name 'Sovereign Debt Crisis' is misleading and can, at best, only account for half of the crisis that is shaking the eurozone's sovereign debt market at the time of writing. Blyth (2013: 5ff) discusses the political ramifications of giving labels for this 'financial-cum-debt-crisis'; Rana (2012) examines the economic consequences of crisis mislabelling drawing lessons from Asia.

raised little concern; the focal point of worry was still the stability of the banking sector. Yet the global financial crisis caused a reassessment of asset prices and growth prospects, particularly for countries with growing macroeconomic imbalances (Lane 2012). When the Greek Finance Minister announced in October 2009 that the debt ratio for 2009 had been ‘miscalculated’ by the previous government and was 12.8 per cent of GDP, substantially higher than the 3.6 per cent initially reported, Greek access to global capital markets began to decline. The unfavourable country-specific shift in market expectations increased the penalty already imposed by markets due to the country’s deteriorating macroeconomic performance (Argyrou and Kontonikas 2011). Concerns over Greece’s solvency were further stirred when the then ECB president Jean-Claude Trichet announced that the central bank would phase out acceptance of BBB- rated bonds<sup>7</sup> in 2010. This raised concerns that Greek bonds would become ineligible for the ECB’s long-term refinancing operations (LTRO). The ECB’s LTRO provide financing to banks in the Eurozone (see Cour-Thimann and Winkler 2012), with the central aim of providing sufficient liquidity. Since domestic banks are usually key purchasers of sovereign debt, this mechanism was considered as a way to circumvent the ban on bond purchases by the ECB. When the ECB temporarily suspended Greek government debt from being used as collateral in LTRO, all three major credit rating agencies further downgraded Greece’s status to that of ‘junk status’.<sup>8</sup> The resulting adverse borrowing conditions forced Greece to accept the conditionality of EU financial assistance and to give up large parts of its sovereignty in matters of national economic management. Since May 2010, after ‘several long months of protracted negotiation’ (Hodson 2011: 231), eurozone Member States and the IMF have been

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<sup>7</sup> Credit rating agencies, such as Standard & Poor’s, Moody’s or Fitch use an alphabetical system to denote the credit worthiness of debt securities. AAA is accordingly the highest/best rating. Anything lower than a BBB- rating is considered a speculative or junk bond. In addition to the ECB, many government pension funds are required by law to only invest in highly rated bonds (Langohr and Langohr 2008:15). Insurance companies and mutual funds often have similar internal thresholds (ibid. 147).

<sup>8</sup> The initial credit rating downgrade of Greek bonds proved to be the first of many. Overall, between October 2009 and July 2011 Greece was downgraded 6 times by S&P, 6 times by Moody’s, and 7 times by Fitch (Ardagna and Caselli 2012: 4).

providing financial support to Greece through, as of November 2013, two Economic Adjustment Programmes.

The Sovereign Debt Crisis has not been confined to Greece alone; it has put severe pressure on the bonds of other EMU countries and in so doing, brought the focus of free-riding back to the question of stability free-riding. Policy-makers were propelled into creating new institutions in order to provide financial assistance to Member States; the first wave of such assistance was provided under the European Financial Stability Facility (EFSF). As it became increasingly clear that the turmoil in the sovereign debt and financial markets was unlikely to come to an end soon, EU policy-makers agreed to the creation of the European Stability Mechanism (ESM, see Gocaj and Meunier 2013). It was installed in October 2012 as a permanent intergovernmental organisation and took over provision of stability support to eurozone Member States, ring fencing some €750bn for countries in need. Since Greece first received assistance, a further four Eurozone Member States have asked for financial support<sup>9</sup>. In November 2010, Ireland officially requested financial assistance from the EU amounting to a joint financing package of €85bn; this was followed in April 2011 by Portugal, who received a package of €78bn. Spain requested financial assistance in June 2012, worth a total of up to €100bn. At the time of writing, the last country to request financial assistance is Cyprus; it was agreed in April 2013 that the ESM would provide €10bn to the Republic. However concerns remain that other countries may need financial assistance from the ESM. Even six years after the global crisis erupted, EU Member States find themselves with disquietingly fragile macro economies and financial sectors. The contagion effects, particularly felt in the peripheral countries of the Eurozone, reinstalled ‘stability’ as the key public good which needed protecting from free-riding behaviour. The conditionality of the EU financial assistance seeks to provide Member States with an incentive to introduce what is perceived to be group oriented behaviour, namely swift fiscal consolidation and macroeconomic reforms.

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<sup>9</sup> As of late 2013.

## **In the shadow of the Sovereign Debt Crisis**

The Sovereign Debt Crisis has sparked a rapidly expanding literature on the EU's experience, analysing the crisis' causes, considering appropriate policy responses and comparing the trajectories of different countries.<sup>10</sup> In light of the enormous challenges and far-reaching consequences of the Sovereign Debt Crisis, this burgeoning body of work is centred on possible solutions, identified predominantly in new financial regulation and reforming EU economic governance. This focus is understandable. The study of fiscal policy coordination during the Great Recession has been eclipsed by the events of 2010/2011. What is more, given the renewed concern about fiscal consolidation and the quest to identify appropriate instruments to rein in public deficits, the short period of stimulus spending (2008-2010) throughout the developed world seems but a distant memory. This thesis is an attempt to pay attention to a short-lived period of commonly agreed fiscal expansion. I argue that a comprehensive analysis of the determinants of fiscal policy outcomes and their coordination in exceptional times is of interest to those who wish to better understand the possibilities and conditions for collective action in times of crisis and beyond.

### **New aspects of fiscal policy coordination**

Both the rationale for and direction of fiscal policy coordination were shifted by the two crises. Firstly, as will be further explored in Chapter 2, the need and scope for the coordination of fiscal policies was both greater and potentially more beneficial in times of crisis; fiscal policy emerged as a crucial instrument in mitigating the crisis and as such was used extensively. Second, previously 'coordination [had to] be understood as an agreement to enforce fiscal discipline [...] to avoid any spill-over caused by irresponsible policies' (Fatàs and Mihov 2003: 126). It is noteworthy that

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<sup>10</sup> See e.g. Featherstone 2011; Tsoukalis 2011; Begg 2012; Eichengreen 2012; Lane 2012; Schelkle 2011.

prior to 2008, the notion of ‘irresponsibility’ corresponded to exceeding the SGP's 3 per cent deficit threshold. Conversely, this thesis presents an appraisal of fiscal policy coordination considering fiscal crisis responses. Whereas fiscal policy coordination pre-crisis was aimed at curbing Member States’ deficits, the initial goal of the EU’s crisis framework was to bring about coordinated expansion. Heipertz and Verdun (2010) argue the Great Recession opened a new chapter in the history of the SGP. Extending their claim, I argue that the economic and financial crisis has opened a new chapter not only for the SGP but also for EU fiscal policy coordination as a whole. This thesis will chart and analyse its development.

### **The visibility of hard times**

I argue that the variation in fiscal outcomes across countries cannot be fully explained by differences in the economic environment alone. They are not inevitable results of economic imperatives. ‘Public policies seldom, if ever, represent a definitive solution of (*sic*) a problem’ (Majone 1975: 270). Majone’s statement can also be applied to the fiscal policy choices made by EU governments. The hard times of the Great Recession were times of ‘very visible policies’ (Schelkle 2012a: 375). Policy-makers were faced with enormous challenges to stabilise and support national economies and the public finance decisions made during the Great Recession will cast a long shadow. In terms of fiscal policy outcomes the legacy of the 2008 to 2010 period reads bleakly. Debt is on course to continue to rise; Projections by the Commission show that average debt in the EU will rise well above 100 per cent of GDP by 2015 and continue rising to exceed 130 per cent of GDP by 2020 (European Commission 2010).

In terms of the political legacy, the Great Recession has reopened old and largely dormant conflicts. When is austerity ‘too much of a good thing’ (Corsetti 2013)? When is fiscal expansion warranted? When are Member States free-riding on other Member States’ growth policies? In the 1990s such questions sparked tensions when

designing the architecture for a common European currency, testament to which can be seen in the creation and reform of the Stability and Growth Pact whose compound name is an attempt to mollify two frequently conflicting policy goals (Dyson and Featherstone 1999; Heipertz and Verdun 2010). During the Great Recession the debate on the merits of active demand management intensified. Since 2008, Germany has repeatedly been accused of engaging in beggar-thy-neighbour policies, ‘waiting for other less well-placed countries to do most of the work and reaping the benefits once exports pick up’ (*Financial Times* 26.11.2008). In the wake of the Great Recession, charges of stimulus free-riding were replaced by heated debates engaging both policy-makers and academics on the question of austerity policies.<sup>11</sup> Criticism was particularly levelled against the speed of fiscal consolidation. On the one hand, Wyplosz (2013) warned that ‘adopting contractionary fiscal policies in the teeth of a double-dip recession never made sense’. On the other hand, the ECB Vice-President Victor Constancio, consistent with the central banks’ reputation as a fiscal hawk, proclaimed that seeking to stimulate economies by stopping measures aimed at cutting government debt would merely increase countries’ borrowing costs rather than triggering growth (*the Economist* 24.4.2013).

The heightened visibility, or perhaps more fittingly volume, of fiscal crisis responses and crucially the significant consequentiality of said makes the study of public finances in times of crisis particularly compelling. The Great Recession presents a new opportunity to examine EU and domestic level responses to a global economic shock, and by comparing national differences, to draw future lessons for fiscal policy coordination. It is the opportunity offered by a ‘bad-weather test’ (Heipertz and

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<sup>11</sup> The public row surrounding Reinhart and Rogoff’s (2010) influential article “*Growth in a Time of Debt*”, which was repeatedly used as justification for austerity-minded policy-makers such as the German Finance Minister Wolfgang Schäuble (2011), is perhaps the most prominent example.

Verdun 2010: 174).<sup>12</sup> A full appreciation of ‘how we got there’ is especially warranted in the context of the shift of scholarly attention to the on-going Sovereign Debt Crisis and the revamped architecture of the EU’s economic governance. Whilst Featherstone (2012) offers an analysis on the economic governance reform, the EERP is relegated to a mere footnote. The fact that he barely acknowledges the crisis framework that broke away from the fiscal conservatism of the past 20 years is especially puzzling given that his account evolves around the concept of ‘path dependency’.<sup>13</sup> A deeper understanding of the realities of and processes for fiscal policy coordination during the Great Recession should improve our understanding of the post 2011 reforms that have lead to the most comprehensive supranational system of economic and budgetary surveillance to date.

### **Crises as engines of reform**

A rich body of political economy literature establishes the supposition that crisis is the instigator of change (e.g. Nelson 1990; Rodrik 1996). Even prior to Gourevitch’s (1986) *Politics in Hard Times*, social scientists were drawn to the political opportunities created by emergency and crisis: ‘That economic crises seem either to facilitate or outright cause economic reform is part of the new conventional wisdom on reform’ (Tommasi and Velasco 1996: 197).<sup>14</sup> Most of these accounts consider crises to open a unique window of opportunity for change, whose size corresponds to ‘the degree and scope of societal demand’ (Cortell and Peterson 1999: 187, see also Akerlof 1991). This notion of crises as opportunities is particularly prominent in the

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<sup>12</sup> The qualification of ‘good’ or ‘bad’ economic times remains a comparative exercise and may not hold up against future events. For example, Deroose and Langedijk (2002: 216) argue that ‘the rapid economic downturn during the course of 2001 is the first real stress test for the macroeconomic policy coordination framework’. Along similar lines, in his empirical analysis on the enforcement of the SGP, Annett (2006) distinguishes between ‘good times’ (1999-2000) and ‘bad times’ (2001-2004). Revising events amidst the unfolding Sovereign Debt Crisis, Schuknecht *et al.* (2011: 16) conclude that ‘the first nine years of the euro – from 1999 to 2007 – can, in retrospect, probably be best characterised as “wasted good times”’.

<sup>13</sup> See Pierson (2000).

<sup>14</sup> The causal relationship between crises and change have been attested in various contexts, be it war (e.g. Gilpin 1981, Ruttan 2006) or financial and economic crises (e.g. Noble and Ravenhill 2000; Aberbach and Christensen 2001).



literature on institutional change (e.g. Blyth 2002; Widmaier *et al.* 2007; Amable and Palombarini 2009).<sup>15</sup> Whereas McNamara (1998) sees EMU as a result of an neo-liberal ideational shift resulting from the collapse of Keynesian ideas, this thesis considers the move away from the dominating ‘sound finance and monetary paradigm’ (also called ‘Great Moderation’ paradigm) towards first, a speedy embrace of stimulus policies to mitigate the economic fallout and subsequently a deeper understanding and broader definition of macroeconomic stability that preceded the ‘Great Moderation’ paradigm.

Studies on European integration are laden with ‘crisis to change’ accounts (Jo 2007). Monnet (1976) famously proclaimed that ‘l’Europe se fera dans les crises et elle sera la somme des solutions apportées à ces crises’<sup>16</sup>. Dyson follows the shift from the German position of ‘monetary hegemony’ (2000: 646) under the old exchange rate mechanism to a more open competition for cognitive leadership. This initial disturbance of ‘hegemonic equilibrium’ offered small states new scope for influence. A related body of literature inspired by social constructivism has studied the role of ideas on the road to Maastricht and beyond. Marcussen (1998), for example, uses the concept of ‘ideational equilibrium’ in the context of the ‘ideological life-cycle’ to map the genesis of the ideational set-up of EMU. He argues that the disturbance of an ‘ideational equilibrium’ results from external shocks which challenge the shared knowledge structure within the macroeconomic organisational field and lead to periods of ‘critical junctures’ (Collier and Collier 1991). It remains to be seen whether the crises of 2008-2010 will become known as a ‘critical junction’ or a ‘tipping point’ for fiscal policy coordination in the EU, but as the fog of the financial

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<sup>15</sup> Amable and Palombarini (2009) use a neorealist approach to analyse different types of institutional change that may take place in political crisis or systemic crisis. Blyth’s (2002) study of embedded liberalism in twentieth-century Sweden and the United States investigate the relationship between economic policy and economic ideas and evolves around the claim that ideas serve as diagnostic and prognostic devices in the space opened up by an existing crisis. Widmaier *et al.* (2007) discuss the role of wars and economic crises as ‘socially constructed openings for change’ (*ibid.* 747).

<sup>16</sup> Europe will be forged in crises, and will be the sum of the solutions adopted for those crises.

and economic fallout is lifting, it is clear that the crises have spurred a flurry of potentially far-reaching reforms for EU economic governance.

### **Pre-crises fiscal policy coordination**

This thesis examines fiscal policy coordination during the Great Recession. As such it is therefore not the place, for a history of EMU's creation, nor for an extensive review of the SGP application during the first decade of EMU. A little historical context and the introduction of key aspects of fiscal policy coordination are desirable however, in order to make sense of what follows. To this end, this section considers the key development of pre-crisis fiscal policy coordination, before turning to the creation of the EERP in 2008. In the course of the Great Recession, the weaknesses of the existing framework for fiscal policy coordination have become apparent and early warnings about its ability to survey and manage public finance have been confirmed (e.g. Eichengreen and von Hagen 1996, Kopits and Symansky 1998). Despite impressions to the contrary, the procedures for fiscal policy coordination are quite extensive, although reinforced with little political and legal power. The array of committees, mechanisms and processes aimed at effective fiscal policy coordination has progressively been increasing during the last decade. The rationale for, and history surrounding, the creation of the SGP are thoroughly documented; Heipertz and Verdun (2010), for example, have directed much attention to analysing the creation and development of the SGP. Their work remains the most comprehensive and insightful study of the Pact to date, amidst a rich body of literature on the SGP's birth, implementation and related questions of fiscal policy coordination.<sup>17</sup> Whilst it was agreed during the Dublin European Council on 14 December 1996, the Pact's origins date back to a proposal by the then German Finance Minister Theodor Waigel (encouraged by the Bundesbank) in 1995, which insisted on the necessity of a fiscal

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<sup>17</sup> E.g. Gros and Thygesen 1992; Eichengreen 1996; Frieden *et al.* 1998; Dyson and Featherstone 1999; Heisenberg 1999; Hughes Hallett *et al.* 1999; Bruncila *et al.* 2001; Buti and Sapir 2002; Dyson 2000.

rule that would prevent countries with poor records of fiscal discipline from attempting to 'free-ride' on the budgetary 'prudence' of other states.

The SGP regulates multilateral budgetary surveillance in a twofold manner. First, its preventive arm, as expressed in Regulation 1466/97, specifies a deficit limit of 3 per cent of GDP,<sup>18</sup> which provides an early warning mechanism that may lead to policy recommendations being made to a Member State if deemed necessary. Secondly its dissuasive arm, expressed in Regulation 1467/97, governs the Excessive Debt Procedure (EDP), which is triggered if the deficit should breach the 3 per cent threshold. The decisions on the EDP are subject to a highly politicised procedure that notably involves the consent of Ecofin, the Council of Economic and Finance Ministers. Theoretically, non-compliance of Eurozone Member States could lead to sanctions of between 0.2 and 0.5 per cent of GDP.

The economic and political logic of the Pact was contested from the first moments of its creation. Notably, Jacques Delors, the architect behind the new currency union, considered the provisions a 'great disappointment' (Dyson and Featherstone 1999: 741); his vision of EMU was one where a balance between the economic and monetary pillar should be ensured by comprehensive economic policy coordination. Yet the SGP was strongly biased towards a preoccupation with monetary policy, whilst fiscal policy was to be evaluated by its low-inflation merits. This focus contrasted with Delors' plan favouring fiscal and structural requirements of a viable EMU that would not only be able and willing to address asymmetric shocks, but also be able to advance economic growth and employment. Many prominent economists of the time chimed in with their critique of the SGP. Eichengreen and Wyplosz (1998) for instance assess the costs and benefits of EMU's new fiscal rules, concluding that European governments should put more effort into labour market

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<sup>18</sup> This threshold is often portrayed as arbitrary. Larch *et al.* (2010:18) however explain that this reference value was chosen because in the early 1990s it was the maximum deficit that, with an average GDP growth rate of 3 per cent in and an inflation target of 2 per cent, was consistent with a declining debt level.

reform and not rely on single-minded fixation with deficit reduction. In a similar vein, Buiter *et al.* (1992) argue that the fiscal convergence criteria,<sup>19</sup> which later morphed into the SGP, should be disregarded entirely or applied only loosely in order to avoid the risk of serious ‘fiscal overkill’.

### **The SGP in action**

The first application of the SGP came in the spring of 2002. Portugal had run up a deficit of 4.4 per cent of GDP in 2001 and was expected to continue to run a deficit of over 3 per cent the following year. A month after the Commission had issued a recommendation for an early warning, Ecofin declined to provide their endorsement, arguing that there was not yet cause for concern, even if the government’s budget deficit was to rise quickly (Leblond 2006). Despite this, the Commission launched the EDP in July 2002 and recommended a programme for the correction of the deficit under article 104(6), which was agreed by the Council of Ministers on 5 November. When a new centre-right government came to power under Manuel Barroso in May 2002, the deficit was brought below the threshold. In light of this consolidation effort, Ecofin decided to revoke the earlier decision on the existence of an excessive<sup>20</sup> deficit in May 2004, despite the fact that Portugal was very likely to breach the reference value again in that very year.

After this relatively non-confrontational application of the SGP, the real test for EMU’s fiscal rules arose in 2003 when the French and German deficits were (again) above the 3 per cent threshold. As stated in Articles 104 (9) and 104 (11) of the EC Treaty, the Council decided in January and June 2003 on the recommendation to

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<sup>19</sup> The Convergence Criteria presented in Article 121(1) of the EC Treaty establish the degree of economic convergence, which the Member States must attain in order to qualify for eurozone membership. Economic convergence is evaluated in the annual convergence programmes for applicant Member States and stability programmes for eurozone Member States according to a set of macroeconomic indicators found in the 1992 Maastricht Treaty; inflation rates, interest rates, sound public finances, sustainable public finances, and nominal exchange rates.

<sup>20</sup> All subsequent mentions of excessive deficits refer to the characterisation of excessive deficits according to the SGP (i.e. exceeding 3 per cent of GDP).

Germany and France respectively, labelling their deficits ‘excessive’. In addition to a strongly rooted support for fiscal prudence and stability, the symbolism of receiving a ‘blue letter’ from Brussels with regards missed deficit targets is particularly humiliating in the German context; even schoolchildren know to associate it with the embarrassing warning letters schools send out every summer in order to pupils who are about to fail a class. Commentators and oppositional politicians echoed this ‘humiliation’ aspect (see e.g. Howarth and Rommerskirchen 2013).

The suspected weakness of the Pact was confirmed, when on 25 November 2003 Ecofin suspended the EDP for France and Germany. Protest was heard, particularly from the Netherlands, Austria, Finland and Sweden. The Dutch finance minister, Gerrit Zalm, even accused the bigger Member States of ‘bullying’ smaller ones, complaining that some countries had been intimidated by France and Germany (*Sunday Times* 30.11 2003). Many observers and scholars observed the absence, and eventual suspension, of sanctions as the death of the Pact (e.g. Collignon 2003; de Haan *et al.* 2003; Begg and Schelkle 2004).

Due to the non-application of the EDP, the Commission pursued legal action against the Council (C-27/04), although with little success: The European Court of Justice (ECJ) ruling scolded Ecofin, stating that it ‘cannot depart from the rules laid down by the treaty’ (*Financial Times* 13.07.2004). However at the same time, the Court avoided key questions on the nature and the concatenation of the SGP’s procedure, as well as on the division of power between Council and Commission in the enforcement of national budgetary discipline (Dutzler and Hable 2005). The ECJ ruled that the Council had the right to not adopt the Commission’s recommendation, but that it did not have the right to then adopt its own recommendation instead, thus overwriting the Commission’s proposal. The decision gave the Eurozone governments leeway in interpreting the EU’s controversial set of budget rules ‘leaving [the Pact] vulnerable to political manoeuvres in Ecofin’ (Sadeh 2006: 11).

The decision of the Council of Finance Ministers in November 2003 not to impose sanctions on countries that had breached the deficit limit for two years in succession left the Pact in limbo throughout 2004. Most Member State governments sought reform. Notably, the German Chancellor and French President had both called for a softening of the Pact on numerous occasions between 2003 and 2005 (e.g. *Le Monde* 16.07.2003; *Handelsblatt* 18.03.2005). The exact content of proposed reforms differed vastly across the political spectrum with some, such as the Netherlands, calling for a stronger Pact and others such as France demanding more flexibility and stronger engagement in policy coordination (Howarth 2007). In June 2004 the European Council asked the Commission to deliver proposals for clarifying and strengthening the implementations of the Pact (CEC 2004). A consensus on the reform of the SGP was finally reached on the 20<sup>th</sup> of March, after fierce debates in the Eurogroup<sup>21</sup>, the European Council and Ecofin.

### **Reforming the SGP**

An important change in the 2005 reform of the Pact was the introduction of differentiated ‘medium-term objectives’ (MTOs). Whereas the old Pact merely stated that Member States should maintain medium-term budgetary positions that are ‘close to balance or in surplus’, under the new Pact each Member State presents its own state-specific MTOs. While maintaining a safety margin with respect to the 3 per cent deficit limit, the MTOs should take into account the economic characteristics of each state, in particular the debt-to-GDP ratio and potential growth. The reformed Pact also introduces new provisions concerning the adjustment effort that should be made in order to reach the MTOs. This adjustment should be equal to 0.5 per cent of GDP per year as a benchmark, with more effort in good times, and possibly less in bad times. Furthermore, the Commission may issue policy advice to encourage Member States to pursue the structural adjustment path towards their MTOs.

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<sup>21</sup> The Eurogroup consists of economic and finance ministers of the eurozone only (although other Member States may be invited as well). The Eurogroup is an important forum for dialogue with regular attendance of the ECB President and members from the Commission.

A central revision of the EU's fiscal rules is the extension of the exemption from the deficit threshold. Whereas previously only negative growth and events outside the control of the Member States were permissible, a Member State can now evoke, for instance, systemic pension reforms or a sustained period of low growth which will allow for a postponement of the steps towards being reprimanded or even fined under the EDP (Schelkle 2009: 8). The negotiations of these 'expenditure exceptions' were not unlike a bazaar where each state tried to make bargains and cater to their personal budgetary realities and preferences (for a summary see Morris *et al.* 2006).

The existing escape clause within the SGP was left unchanged by the 2005 reform. This clause stipulates two specific conditions that warrant the breach of existing rules: closeness and temporariness. First, the waiver provision stipulates that a deficit of more than 3 per cent of GDP should not be considered excessive and hence may warrant an exemption of the rules *if and only if* it stays close to the 3 per cent threshold (TEU 126, 2-3). Concretely, the Regulation on speeding up and clarifying the implementation of the EDP (EC Regulation No. 1467/97) specifies that in order to fall under the escape clause the deficit ratio has *always to remain close* to the reference value. Secondly, any excess over the reference value must be temporary. In order for the excess to be considered temporary, the Commission's budgetary forecast must indicate that the deficit will fall below the reference value following the end of the unusual event or the severe economic downturn. Any deficit above 3 per cent that is neither close to the reference value nor temporary should be considered excessive, irrespective of exceptional circumstances.

The reformed Pact was applied at time of a strong economic upturn. To the degree that the economic climate improved, so too did compliance with the SGP. In 2008 the Commission presented an optimistic scenario for public finances in the EU: with the abrogation of EDPs for the Czech Republic, Italy, Portugal and Slovakia in June

2008, procedures only remained active for two non-euro-area members, Hungary and Poland, with the latter then expected to soon come to a close (European Commission 2009). Yet despite broad compliance even before the crisis hit, European fiscal policy coordination remained contested. In particular the newly elected French President, Nicolas Sarkozy, challenged the ‘pseudo-dictatorship of the market’ (*New York Times* 5 July 2007) and announced that France would put off balancing the French budget until 2012<sup>22</sup>. A likely conflict between Germany and France on a strict implementation of the SGP was prevented by the economic and financial crisis.

After a first decade of seeking to coordinate fiscal policies at the EU level, few would argue that fiscal policy coordination was a success. What does the failure to coordinate fiscal constraints in comparatively rosy times tell us about the prospects for coordinating fiscal crisis responses? An implicit assumption running through the SGP literature is that of the ‘deficit and debt bias’ of modern democracies. In a nutshell, policy-makers who wish to maximise their electoral support are said to incur larger budget deficits than would be advisable according to the ‘sound finance paradigm’. The SGP sought to counter-balance this bias with a clear commitment towards ‘sound’ fiscal policies. But in times of crisis the challenge was not to coordinate fiscal constraints, but fiscal stimulus policies. Given governments’ deficit spending propensity, is this task likely to be easier than the task of imposing fiscal constraints? If governments resisted a deficit ceiling, would they be more inclined towards group oriented behaviour that expressly encourages expansive fiscal policies?

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<sup>22</sup> In its 2009 opinion on the existence of an excessive deficit, the Commission report (SEC 2009, 569 final) calls out a lack of consolidation effort: ‘Apart from the above-mentioned economic downturn impact, the excess over the 3 % threshold from 2008 is also a reflection of the fact that, since 2002, the deficit in France has been high and, either above, or still close to the 3 % threshold, therefore not providing any room for manoeuvre for a downturn, either whether severe or normal. The structural balance deteriorated in 2007, although economic circumstances were better and the government did not plan a significant structural adjustment for 2008 either, when the economic outlook was still substantially more favourable. Even after the previous existing deficit procedure was abrogated in early 2007, and despite repeated commitments for an acceleration of the budgetary adjustment in successive stability programmes and related Council recommendations, as well as in its policy advice of 28 May 2008, the necessary fiscal consolidation was not carried out or planned.’



## **The framework for fiscal policy coordination during the Great Recession: the EERP**

The first wave of crisis reactions in 2008 did not address the question of stimulus coordination, but was instead aimed at the financial sector. In keeping with fiscal response strategies, these efforts were predominantly unilateral (Pauly 2009). Seemingly oblivious to the clear signs that the financial crisis would have severe repercussions for the real economy, the Council's conclusion (ECOFIN 2008) on October 7<sup>th</sup> 2008 stated that the reformed SGP 'is the adequate framework and should be fully applied. It contains flexibility to allow for fiscal policy to play its normal stabilisation function [...] relatively large European automatic stabilisers can help cushion the slowdown, while respecting the 3 per cent of GDP deficit threshold.'<sup>23</sup> That is to say, the Pact did 'not allow for discretionary fiscal expansions, unless a country has significantly over-achieved its budgetary objectives' (Larch *et al.* 2010). At an emergency summit on October 12, Member States reached an agreement on national responses to ensure liquidity for financial institutions (Quaglia *et al.* 2009); yet concrete fiscal policy measures and targets were not addressed. Instead, Member States vaguely pledged 'to coordinate measures to address the consequences of the financial crisis on the real economy' (Eurogroup 2008); key terms such as 'stimuli or 'discretionary spending' were notable only in their absence. On October 29, stimulus measures were publicly, albeit in meaning and not in name, on the agenda of the Commission with the Communication 'From financial crisis to recovery: A European framework for action' (European Commission 2008). Here the Commission laid the groundwork for what would become an attempt to coordinate fiscal stimulus programmes in the EU. Fifty days

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<sup>23</sup> According to one interviewee 'the crisis hit us at the Commission by surprise. I remember the very same day when Lehman went bust, we were gathering for the autumn forecast and beaming with optimism, among other things because it looked like Germany had finally overcome its structural crisis' (author interview, May 2011). Along similar lines one interviewee from the Commission conceded that 'the amplitude of crisis came as a big surprise' (author interview, March 2011). The Commission was hardly alone in its underestimation of the crisis. Jean-Claude Juncker, then chairman of the eurozone finance ministers, proclaimed in September 2008 that '[it] shouldn't be said that Europe is on the brink of recession' (quoted in Barber 2008).

after the initial re-endorsement of the 3 per cent deficit threshold, the Commission finally proposed a more detailed EU recovery framework on November 26.

In the preface of the EERP, the Commission introduced the plan as a bold policy initiative in times of crisis, presenting itself as a leader in such times. According to the recovery plan, national budgetary stimulus packages should fulfil four criteria: First they should be *temporary*. That is to say, measures under the EERP (2008) to boost demand must be designed to deliver ‘immediate effects, be of limited duration’. Secondly, they should be *targeted*. In other words, policy measures must be aimed at those sectors most affected and the most important with regards the structure of the economy, such as the automotive industry or the construction sector. Thirdly, measures should be *timely* so that they quickly support economic activity during the period of low demand, as delays in implementation could mean that the fiscal impulse only comes when the recovery is underway. Finally, stimulus packages should be *coordinated* so that they multiply the positive impact and ensure long-term budgetary sustainability.

At the heart of the EERP is the call on Member States to implement an immediate budgetary impulse amounting to €200bn (1.5 per cent of EU GDP), comprised of a budgetary expansion by Member States of €170bn (around 1.2 per cent of EU GDP), and EU funding in support of immediate actions of the order of €30bn (around 0.3 per cent of EU GDP). The EU funding was mainly invested into infrastructure programmes and linked to other existing programmes such as the European Structural Funds and the European Globalisation Adjustment Fund: a) €5bn of unspent money under the EU budget to trans-European energy inter-connections and broadband infrastructure projects, b) €500 million call for proposals for trans-European transport projects (where this money will lead to construction beginning before the end of 2009), c) €5bn ‘European green cars initiative’, which was essentially a research partnership between the public and private sectors (including the European Investment Bank (EIB), and industry contributions) on smart

infrastructures and technologies for using renewable and non-polluting energy sources for cars, d) €1bn 'European energy-efficient buildings initiative'.

Correspondingly, the EIB increased its financing of climate change, energy security and infrastructure investments by up to €6bn per year. This is part of a strategy aimed at giving the EIB a larger role in economic recovery; its annual interventions in the EU were accordingly increased by some €15bn in 2009 and 2010. The European Bank for Reconstruction and Development added a further €500 million to its present level of financing in the new Member States in 2009 and 2010. Given that all initial sources for these projects stem from the Member States themselves and that in some instances (e.g. the European green cars initiative or an increase in EIB lending) the Member States were asked to contribute more money, the official distinction between EU funding and national funding is somewhat misleading.

The EERP (2008) includes the understatement that fiscal efforts 'may lead some Member States to breach the 3 per cent GDP deficit reference value'. In fact, all Member States except Sweden and Estonia were in violation of the 3 per cent ceiling at some point between 2008 and 2010. Furthermore, the EERP (2008) relaxes the '*temporary*' criterion of the SGP; the speed of corrective action was contingent on the speed of recovery, which meant that the Commission introduced greater leniency with respect to rectifying the excessive deficit situation. The EERP neglected to make explicit or implicit reference to the 'closeness' criterion of the Pact. The qualification of Joaquín Almunia 'that [close] means a few decimals, not many decimals' (quoted in Tait 2008), did not find its way into official agreements or guidelines. The EERP does not introduce an actual limit on stimulus spending, either in absolute or in relative terms. The European Council approved the EERP on 12 December 2008, in doing so advocating a recovery plan that was seemingly at odds with a strict reading of the SGP. This development is noteworthy. After decades of championing low deficits and debt levels, the Commission emerged as an unlikely advocate of stimulus policies throughout the European Union, relaxing the application of existing rules under the SGP. The crisis framework laid out in the

EERP represented a first attempt not to coordinate fiscal constraints, but rather fiscal expansion.

### **The Structure of this Thesis**

This study explores the state and dynamics of fiscal policy and its coordination amongst EU Member States during the economic and financial crises of 2008-2010. The subsequent chapter unpacks the concept of coordination and examines the rationales for and against fiscal policy coordination in the EU in the context of policy interdependence. The basic argument in favour of fiscal policy coordination is found in the need to internalise externalities arising from spillover effects. In times of crisis the externalities of fiscal policy choices are potentially greater due to an increased scope for government action. The challenge for fiscal policy coordination in times of crisis is then to prevent two types of free-riding behaviour. The first, growth free-riding, arises when one country benefits from other countries' expansive fiscal policies, whilst the second, stability free-riding, considers the hazard of fiscal expansion, which would threaten the stability of the eurozone/EU.

Chapter three discusses the conceptual framework, research hypotheses and methods of the thesis, beginning with an introduction to the theoretical centre of this research: collective action theory. Olson's (1965) body of work is the starting point of the three main hypotheses considering the EU's group latency, incentives for collective action and free riding behaviour. These hypotheses will be tested using a mixed-methods approach consisting of qualitative and quantitative methods. This combination of nuanced interview material with arguably more blunt econometric techniques espouses methodological pluralism and seeks to enrich our understanding of the subject at hand. Before engaging in hypotheses testing, the fourth chapter considers adequate measurements for fiscal policy outcomes and fiscal policy coordination in times of economic and financial crisis. Finding appropriate indicators that are able to reflect discretionary policy choices is challenging given the substantial role of

automatic stabilisers, dubious aggregation techniques to boost stimulus figures and the accounting of financial sector rescue operations. This study therefore adopts a centripetal measurement approach, relying on different measures with diminishing policy discretion. The four dependent variables measuring fiscal policy outcomes are the budget balance, the primary budget balance, the structural balance and the primary structural balance.

Having identified suitable fiscal policy indicators, chapter five provides an empirical investigation into the determinants of public finances during the Great Recession, analysing time-series cross-sectional data from the 27 EU Member States over a 3-year time period (2008-2010). Post-war economic history provides evidence that fiscal authorities in industrialised countries may be prone to a deficit-bias, which shows up in large and persistent deficits and growing public debts. The empirical analysis shows that this bias is stronger during the Great Recession and that political-economy factors have indeed shaped public finances. This suggests that fiscal policy was not merely driven by economic conditions, but a complex result of intervening political features. This finding has important implications for fiscal policy coordination. Given the heterogeneous political landscape of EU Member States, with a different electoral calendar, partisan outlook, executive and legislative makeup, fiscal policy outcomes are likely to be heterogeneous across Member States. The importance of political determinants of crisis responses suggests that there was a danger of Member States either under- or over-stimulating their national economies, in other words free-riding. Deterrents to free-riding are thought to be found in the provision of separate and selective incentives.

Chapter six scrutinises two types of different incentives that are thought to affect fiscal policy choices; fiscal rules and market discipline. The empirical findings suggest that domestic fiscal rules such as debt brakes, did not impact on the fiscal policy responses to the Great Recession. Similarly, EU level fiscal agreements, the SGP and the newly created EERP, did not impact on fiscal policy choices. In contrast

to these fiscal rules and intergovernmental agreements, the incentives provided by market discipline are found to steer public finances. Importantly, this effect is stronger for eurozone Member States, whose fiscal policy choices and outcomes – in the absence of debt monetization – are viewed more critical by financial market participants. These findings show an asymmetry: while stability free-riding was punished by the existence of separate and selective incentives in the form of market discipline, there were no effective incentives in place to limit growth free-riding. Neither fiscal rules, be they EU or domestic in nature, nor market participants disciplined policy-makers who failed to stimulate the national economy. This asymmetry is interesting given that prior to 2010 the discourse on free-riding focused predominantly on growth free-riding. What is more, the 2011 created Macroeconomic Imbalances Procedure (MIP), which aims to prevent and correct imbalances throughout the EU, is clearly biased towards debtor countries (cast as likely stability free-riders) although it recently started to recognise the consequences of imbalances found in surplus/creditor countries (likely growth free-riders).

Chapter seven investigates both stability and free-riding behaviour. Accusations of stimulus or growth free-riding are not borne out by factual evidence. First, the findings of this chapter suggest that countries with a stronger export position, a larger population, and a larger economy implemented larger, not smaller, stimulus programmes. Secondly, countries with limited fiscal space, as set out in the EERP, did by and large abstain from large stimulus programmes. This study will conclude by considering future developments in fiscal policy coordination. I argue that as ‘stressful heterogeneities’ between EU Member States are increasing, the importance of Olsonian incentives to induce group-oriented fiscal policy outcomes will increase. Despite apparent shortcomings in the wave of economic governance reforms post-2011, some elements of the new economic governance architecture, particularly the Macroeconomic Imbalances Procedure (MIP), may pave the way towards a comprehensive system of macroeconomic policy coordination that covers both forms of free-riding. Furthermore I discuss market discipline and stability free-riding

post-2011 and chart some of the future challenges and tensions in financial-market-sovereign state relations. I conclude by challenging the claim of the powerless EU Member State.

## CHAPTER 2: FISCAL POLICY COORDINATION

### Introduction

Hardin (2009: 96) describes coordination as the ‘the central mode of social order in a complex modern society’. Accordingly, a central quest in political science is the identification of not only arguments in favour of coordination, but also of modes to ensure and eventually optimise coordination. Hobbes’ (1983, 1642) answer to the latter question lead him to the all-powerful sovereign ensuring institutionally enforced coordination, Hume (2000, 1739) pointed to convention as a form of spontaneously imposed coordination, Schumpeter’s (1934: 80) evolutionary account saw coordination achieved through ‘decades and, in fundamentals, through hundreds and thousands of years’, Schelling (1960) put coordination at the centre of game theory and Pareto (1971) revolutionised the field of study with his value theory, to name but a few. Hardin’s account of coordination also applies to the EU where fiscal policy coordination was thought to ensure ‘the central mode of [fiscal] order’ in a complex system of interdependences.

This chapter is organised as follows: it begins by unpacking the concept of coordination and examining the rationales for and against fiscal policy coordination in EMU. It starts by considering what exactly coordination means, how it differs from related policy actions and outcomes such as co-operation, convergence, harmonisation and cohesion, before presenting arguments for and against fiscal policy coordination. The arguments highlighting the benefits of fiscal policy coordination in the EU revolve around the concern of free-riding, whilst the arguments against coordination focus on concerns of efficiency and legitimacy. Although some of the considerations, specifically when discussing monetary policy, apply to eurozone Member States only, the overall theme of this chapter, collective action as a means to manage interdependence, holds true for the EU27 as a whole and more broadly.



## Coordination – an appraisal

In their analysis on international economic policy coordination, Horne and Masson (1987) stress the importance of being clear and precise with terminology. In analysing fiscal, as well as other forms of, policy coordination several closely related concepts emerge, namely co-operation, convergence, cohesion, and harmonisation. All four terms are currently used to describe different processes found in the framework for EU macroeconomic policy-making. Convergence is associated with the Convergence Criteria presented in Article 121(1) of the EC Treaty, which establishes the degree of economic convergence that Member States must attain in order to qualify for Eurozone membership. Economic convergence is evaluated in the annual Convergence Programmes for applicant Member States and Stability Programmes for Eurozone Member States according to a set of macroeconomic indicators found in the 1992 Maastricht Treaty, namely inflation rates, interest rates, sound public finances, sustainable public finances, and nominal exchange rates. The overall aim of these programmes is to ‘ensure more rigorous budgetary discipline through surveillance and coordination of budgetary policies within the euro area and EU’ (Ecofin 2009). In the eyes of the Directorate General of Economic and Financial Affairs (DG Ecofin), convergence is hence achieved through coordination.

Related to the policy programme of convergence is the concept of cohesion. In particle physics, cohesion is the force with which the particles of a body cleave together. The role of the EU’s cohesion policy is, by reducing disparities in economic performance among European regions, to create the same kind of force that should help the Union to hold together. The principle of cohesion, ever since the reform of the Structural Funds in 1989, is one of the EU’s key policies regarding macroeconomic reform of the Member States’ economies.<sup>24</sup> Especially in the light of the Eastern enlargements, the Cohesion Fund has more than doubled in real terms

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<sup>24</sup> In theory, EU Member States can make the disbursement of Cohesion funds conditional on SGP compliance (see the example of Hungary discussed in the concluding Chapter 8).

since the late 1980s. €347bn have been allocated for cohesion funds for the period 2007-2013, more than 80 per cent of which is targeted at promoting ‘convergence’ (Farole *et al.* 2009). Cohesion policy as a tool for macroeconomic policy coordination focuses on two principles of decision-making, concentration – decisions on where the money is spent – and programming – decisions on how it is spent (Bachtler and Mendez 2007).

The harmonisation of economic policies has, generally speaking been used in a rather restrictive sense to refer exclusively to microeconomic policies. It describes the application of national regulations in order to achieve greater uniformity in economic structures across countries, e.g. competition policy and internal market rules. The instrument of harmonisation is perhaps the most dominant one in the history of European integration through harmonisation by law. As the reach of EU law expanded, this method met with increased resistance. Indeed, in areas where harmonisation is impracticable (such as harmonisation of fiscal policy in the EU) or counterproductive (again, this argument can be made with respect to harmonisation of fiscal policy where ‘one size does not fit all’) and the resulting regulatory competition may be too sensitive, the method of policy coordination by which national standards and practices are made compatible instead of harmonised is considered superior (Hartwig and Mayer 2002).

The phrase ‘policy co-operation’ encompasses broader forms of interaction between actors. While coordination always needs co-operation in order to be efficient, co-operation can take the form of uncoordinated action. Hence co-operation ‘falls well short of coordination a concept which implies a significant modification of national policies in recognition of international economic interdependence’ (Kenen *et al.* 2004: 78). Co-operation consists generally of consultations, information interchange and international surveillance. Based on this definition it would be sensible to

rename the OMC the Open Method of *Co-operation*.<sup>25</sup> A systematic review of the relevant legal and political texts on EMU reveals that the term *co-operation* is predominately used to denote action between institutional actors such as the Commission, the Council and the ECB, and between the bodies of the Member States. The term ‘coordination’ is used for fiscal and macroeconomic policies. Overall the distinction, although not always clear cut, seems to be one of policies versus actors.<sup>26</sup>

Following Currie *et al.* (1989: 14), in this thesis ‘the establishment of agreed rules of the game in the macroeconomic sphere that constrain, or determine, at least some instruments of macroeconomic policy is to be regarded as a form of policy coordination’. Coordination implies mutually agreed modification in the participating state’s national policies. Such modification calls for more or less explicit, operational commitments about the conduct of the specific policy area and necessitates clear commitments to targets. Targets in themselves do not constitute coordination, merely a measurement for its effectiveness.

### **Interdependence and coordination**

One term stands out in all explanations as to why sovereign states would agree to coordinate (fiscal) national policies: interdependence. The earliest entry that the Oxford English Dictionary offers in order to illustrate its meaning stems from a letter by Samuel Coleridge (1822), in which the poet alludes to his ‘unfitness for a state of moral and personal union and life-long interdependence’. EMU membership has frequently been compared to a marriage. Even before the negotiations on the road to

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<sup>25</sup> See Armstrong (2010: ch. 2) for a discussion on labels and naming in the OMC.

<sup>26</sup> A competing distinction can be found in Biagi (1998), who distinguishes between policy coordination as ‘co-operation’ and coordination as ‘convergence’. While ‘co-operation’ works with the autonomy of states to define their policies but promotes elective and selective learning across states, ‘convergence’ implies that the process is not agnostic about what states can and ought to learn with a potential consequential reduction in policy diversity. This distinction is however less helpful in the context of fiscal policy coordination, as it clearly has elements of both co-operation and convergence.

Maastricht, this metaphor has invited political scientists and economists to muse about the nature of monetary union. Hughes Hallet and Petit (1990) compared the coordination of fiscal and monetary policies in eurozone to a ‘forced marriage’; Thygesen (1993) discusses a ‘honeymoon affect’ for public finances in the run up to EMU; Dornbusch (1996: 110) considers the Maastricht Treaty a ‘prenuptial agreement’; Winkler (1999: 52) argues that ‘candidate countries for EMU play the role of the groom who has to woo a sceptical bride [...] before the EMU marriage’; Dyson (2000: ch.2), asked whether the eurozone was the child of the Franco-German ‘couple’ and Feldstein (2000: 12) stresses that ‘EMU is meant to be a marriage made in heaven with no room for divorce’. While these characterisations do not draw the same conclusions, they all begin with the same implicit premise; the eurozone, like a marriage, is a union characterised by interdependence.

European integration has both strengthened existing and created new interdependence in numerous areas, such as cultural and political matters.<sup>27</sup> This interdependence is first and foremost an economic one; it is sometimes used synonymously with ‘openness’, which merely refers to a state’s exposure to the rest of the world. Whilst there is a close correspondence between the two concepts, it is worth highlighting distinctions between the two. A state can be open but not exert any interdependence because it is too small to influence conditions in the rest of the world, however at the same time a state can be highly interdependent in relation to another, but by no means be regarded an open economy. Elaborating on their conceptualisation of interdependence, Keohane and Nye (1987) present the concept of asymmetrical interdependence, according to which interstate power originates not from the possession of coercive power resources, but from asymmetries in issue-specific interdependence. Such asymmetric interdependence is part and parcel of the EU’s Member States’ intergovernmental relations.

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<sup>27</sup> The relationship between integration and interdependence is not a EU phenomenon; for a broader discussion of the link between globalization and interdependence, see Kayser (2007).

Discussions on the causal relationship between interdependence and coordination have a standing tradition in both political science and economics. Wallich's textbook definition (1984: 85) makes the link explicitly, defining coordination as 'a significant modification of national policies in recognition of international economic interdependence'. The literature on economic interdependence and conflict supports the claim of a 'liberal peace' (e.g. Mansfield 1994; Gartzke and Li 2003; Oneal *et al.* 2003; Press-Barnathan 2006). While these accounts are not uncontested, particularly with respect to post-colonial trade linkages, the idea of a *pax mercatoria* is hardly as accepted elsewhere as in the literature on European integration. The creation of the EU is largely understood to be the most successful peace building and sustaining operation of the 20th century (e.g. Garton Ash 2005; Habermas 2008), with which the growing interdependence between EU Member States, political integration and building of institutions has gone hand in hand. Fittingly, the title of Monnet's biography (Duchene 1994) refers to the former President of the European Commission as the 'first statesman of interdependence'. As the intensification of intra-EU trade relations, interwoven financial sectors and heightened powers of community institutions show, this interdependence has been on a steep upward slope since the days of Monnet. The past crises have painfully shown the negative ramifications and increased challenges of interdependence.

### **Interdependence and public goods**

Interdependence creates the need for collective action. The starting point of the logic of collective action in international relations is the so-called moral hazard problem. The classic economic definition of moral hazard refers to the 'observation that a contract which promises people payment on the occurrence of certain events will cause a change in behaviour to make these events more likely' (Black *et al.* 2009: 139). Moral hazard refers to a situation when one group member does not bear the full consequences of its action and consequently has an incentive to act less cautiously or even in a hazardous way because other members bear (part of) the

costs. A member (partly) insulated from risk may behave differently than if fully exposed to risk. This situation is referred to as a social dilemma, the analysis of which dates back to Olson's seminal work (1965) on the logic of collective action. Olson's work rests on a single premise: that individual rationality is not sufficient for collective rationality. He notably described how, due to the strong incentives to free ride for each individual, a situation in which the benefits of a public good cannot be successfully limited to those who positively contribute to its generation causes this good to be provided at sub-optimal levels, if at all. In the EU, the need for fiscal collective action is specifically due to the high sensitivity of interdependencies. In understanding why EU Member States would desire fiscal policy coordination, it is useful to consider fiscal policy as producing public goods.

Since Adam Smith's enumeration of public goods, the list of public goods has expanded over time.<sup>28</sup> Classic/pure public goods are defined by two characteristics: non-rivalry and non-excludability. First, the consumption of this good by one party does not reduce others' ability to consume it. The second condition refers to the good being in joint supply; one party cannot be supplied without simultaneously supplying also others. The definition of fiscal policy public goods is less straightforward than for instance other pure public goods, such as lighthouses or national defence. Within an economy, fiscal policy involves the setting of both the provision of the public goods decided upon and their financing through taxes and/or debt. Many public goods provided through fiscal policy are exclusive to a certain group fulfilling specific group criteria. This type of public good can be called a discriminatory public good (e.g. unemployment benefits, schools). Conversely, the consumption of non-discriminatory public goods (e.g. national defence, roads) is not restricted to group eligibility. A further distinction can be made between goods that are non-excludable but whose consumption is rivalrous: so-called common-pool resources. Economists describe the common-pool problem as the phenomenon of unrestricted access to a

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<sup>28</sup> Smith's understanding of public goods was limited to law and order and public service that are not profitable for individuals to do themselves.

resource resulting in overuse, until its marginal value drops to zero. Public finances, with its constrained pool of money to be allocated, represent a classical common-pool resource. The deficit bias of governments is often accounted for by referring to politicians who represent different electoral groups and have no incentive to limit their spending demands given that the costs are shared by the population as whole (Hallerberg and von Hagen 1997). These asymmetries in the allocation of costs and benefits of spending programmes can then produce spending and deficit biases (see also *inter alia* Buchanan et al 1987; von Hagen and Harden 1994; Velasco 2000; Persson and Tabellini 2000).

The interdependencies of the EU and to a larger extent the eurozone, economies make fiscal policy outcomes an international public good.<sup>29</sup> Such public goods cover more than one group of countries. EU Member States' economic and, by implication, fiscal policies are regarded as a 'matter of common concern' (Article 121 TFEU). To this end, the need for improved coordination between the economic policies of the Member States has been recognised both in the TFEU and in the overall economic governance framework. The international public good in question, fiscal policy in the EU, is not concerned with single spending measures but with the aggregation of all fiscal expenditure and revenue, i.e. a country's fiscal stance. The common concern, as will be addressed in more detail below, relates predominantly to overall macroeconomic stability, which was thought to be secured by sound monetary policy (read an inflation rate of close to, but below 2 per cent) and fiscal policies (read deficits below 3 per cent of GDP).

The initial economic and financial crisis erupting in 2008 and to a greater extent the Sovereign Debt Crisis, have given testimony to the interdependence of national economies. By eliminating currency risk and reducing transaction costs within the eurozone, the introduction of the new European currency has strengthened cross-

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<sup>29</sup> Analogous names are 'transnational public good' (Sandler and Arche 2002), 'European public good' (Zuleeg 2009) or 'global public good' (Kaul *et al.* 1999).

border financial market integration in the wake of the economic and financial crisis (Howarth and Quaglia 2013). However as a result, this made the sovereign debt market more vulnerable to contagion effects. In April 2010 for example, Portuguese two-year bond yields rose more than three-quarters of a point to 3.99 per cent, Ireland's jumped by a similar amount to 2.99 per cent and Spain's increased a quarter of a point to 1.87 per cent (*Financial Times* 27.04.2010). In the case of the homemade debt crisis, the interdependence is *endogenous*, stemming from the internal system of interdependence. The financial sector fallout in the autumn of 2008 however illustrates the possibility of *exogenous* structural interdependence. In this case, the original disturbance was exogenous, originating from the credit market in the United States and was triggered by the default of the US investment bank Lehman Brothers in mid-September 2008.

In this thesis, 'fiscal free-riding' refers to both growth and stability free-riding. The treatment of fiscal policy as producing sub-types of public goods is therefore broader than usually found in the literature. For instance Schelkle (2005: 374) defines the key public good as 'monetary stability or low equilibrium interest rates'. This bifurcation (stability and growth) should be considered not in absolute terms but as a conceptual device. What is more, both types of public goods are discriminatory as they are related to the variable interdependence threshold of each Member State. Not all Member States are, for instance, negatively affected by the sharp increase in interest rates on sovereign borrowing. Indeed quite the opposite is true; Germany, as flight to quality ensued, benefited from investors pulling out of troubled EMU states (Beber *et al.* 2009; In't Veld 2013). In a similar vein, closed economies are less affected by other Member States' decisions to stimulate national economic demand. This does not pose a conceptual problem for this research: the literature on public goods is quite accommodating to such nuances and heterogeneous exposures.

The macroeconomic policy interdependence in EMU concerns both monetary and fiscal policies. Monetary policy refers to actions taken (generally) by central banks in



order to affect monetary and financial conditions in an economy. Fiscal policy encompasses the use of the government budget with the view to affecting the volume of national spending, or more generally to provide public goods and services as well as to redistribute income. Examining the enmeshed network of monetary and fiscal policy, one can distinguish between various reasons in favour and against fiscal policy coordination. Notably, these reasons are neither uncontested nor static and increase or decrease in argumentative power in times of crisis.

### **Fiscal policy coordination according to the ECB**

To better understand the reasons for fiscal policy coordination, it is useful to consider the arguments put forward by one of the staunchest supporters of the SGP and its 3 per cent deficit criterion; the ECB. For the ECB, the need for fiscal policy coordination stems from an asymmetry between monetary and fiscal policy.

Monetary policy is taken out of the hands of national policy makers and now rests entirely with the ECB, Europe's 'new Leviathan' (Howarth and Loedel 2005). On the other hand however, fiscal policy, within the confines of the SGP, remains the prerogative of Member State governments. Fundamentally, and according to the theory, monetary policy is only able to control the price level if government solvency is guaranteed (Buti *et al.* 2001). Hence monetary policy seeking to achieve low inflation has to go hand-in-hand with a fiscal policy respecting a solvency constraint. Beyond the issue of solvency, the conduct of fiscal policy impacts on monetary policy generally speaking on two main levels (Doughty 1991). First, fiscal policy interacts with certain elements of the monetary policy transmission mechanism (domestic demand, interest rates, and direct inflation effects). Secondly, fiscal policy interacts with the long term perceived economic sustainability of monetary policy. Given that fiscal policy directly affects the economic environment in which central banks operate, they pay close attention to fiscal developments. As Mervyn King (1995) the ex-governor of the Bank of England, disclosed, 'central banks are often accused of being obsessed with inflation. This is untrue. If they are obsessed with

anything, it is with fiscal policy.’ His characterisation seems to apply to the ECB, as evidenced by the fact that over the past ten years, the ECB has communicated intensively on fiscal policies in both positive as well as normative terms, especially in comparison to other central banks (Allard *et al.* 2012).

Given the policy interdependence between monetary and fiscal policy, the underlying call for fiscal policy coordination was considered to be indispensable if the ECB was to fulfil its mandate. Fiscal policy coordination is therefore guided by the doctrine of fiscal discipline for the sake of price stability. As Wyplosz (2006: 225) points out, the economic logic of the SGP ‘is rooted in the strong evidence that large inflations are always the consequence of runaway deficits that lead to a public debt that cannot be financed anymore through normal market borrowing’. Unsustainable levels of debt would lead to demands of higher wage settlements and higher interest rates by purchasers of government debt to be compensated for expected inflation. As a result governments would try to force monetary financing upon their central banks. Hence the creation of the SGP is a means to prevent central bankers being drawn into an inflationary process. This sentiment is echoed by Beetsma (2001: 29), who sees the Pact as a ‘deterrent to over-expansionary fiscal policies that spill over into higher interest rates and inflation rates for all EMU members’. In sum, fiscal policy coordination from the ECB’s point of view is motivated by concerns over stability free-riding.

By imposing clear limits on public finances, the SGP confines fiscal policy coordination to the EU level and purposely excludes the ECB from the coordination process. While the coordination of fiscal policies guided by the paradigm of fiscal prudence is thought to enhance the credibility of monetary policy in EMU, the coordination between one central monetary policy and national fiscal policies is thought to be detrimental to the ECB’s independence (e.g. Issing 1992; Alesina *et al.* 2001). The ECB therefore explicitly advocates horizontal (coordination of national fiscal policies) over vertical (coordination between fiscal and monetary policy)

coordination, and stresses that the current framework provides for sufficiently efficient assignment of objectives with clear allocation of responsibilities to individual policy-makers and relevant institutions. This assignment, so the argument goes, makes ‘policy coordination of monetary and fiscal policy redundant’ (Masuch and Brand 2002: 16). In comparing policy coordination between fiscal and monetary authorities both under and prior to EMU, Bini Smaghi and Casini (2000) find that coordination efforts have declined considerably. Arguably this weakening is a deliberate move from the ECB to isolate itself from the politicisation of monetary policy, which it fears to be entrenched in the coordination between monetary and fiscal policy. Attempts to coordinate monetary and fiscal policy *ex ante* are, according to Issing (2002:356), ‘very tricky and, in the end, may destroy the balanced institutional framework in EMU with its sound and clear assignment of objectives to the individual policy maker’. This evaluation echoes the warning of Rogoff (1985) that international macroeconomic policy (vertical) coordination threatens the credibility of stability-oriented monetary policy.<sup>30</sup> The reluctance of the ECB to actively interact with domestic fiscal policy becomes further evident with respect to its role as both a ‘policeman and judge’. Howarth and Loedel (2004) distinguish between these two roles concerning the strategic interaction between the ECB and the Eurogroup with regard to the SGP. The authors argue that although the ECB has been known for making public recommendations to EU governments on how best to achieve the Broad Economic Policy Guidelines<sup>31</sup> (BEPGs) (and in doing so fulfilling its role as a policeman by verbally ‘ticketing’ wayward states), it has been somewhat less active in the use of its role as a judge.. That is to say, the ECB has not made use of the interest rate weapon to ‘judge’ the recalcitrant Member State governments despite numerous threats to do so.

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<sup>30</sup> Again, monetary and fiscal policy are interdependent, and interact with one another. Yet this interaction is implicit and not based on overt coordination. Using pooled data for 19 OECD countries including 14 EU Member States for 1960-1995, Melitz (1997) finds strong evidence for ‘strategic substitution’ – that is, monetary and fiscal policy moving in opposite directions (see also Wyplosz 1999 for similar results).

<sup>31</sup> The, now defunct, BEPGs were adopted by the Council in the form of a non-legally binding recommendation and were part of broader macroeconomic policy coordination prior to the post-crisis economic governance reforms (see Deroose et al. 2008).

## **The ECB in times of crisis**

It is worth repeating that at the heart of the construction of the pan-European Stability Culture was the claim that high deficits would cause inflation (e.g. EMI 1996), an assertion that was reiterated in the reformed SGP (e.g. Gonzalez-Paramo 2005). Yet there is strong evidence that the link between deficits and inflation, as expressed by Sargent and Wallace's 'unpleasant monetarist arithmetic' – stating that an increase in public debt is typically inflationary – is tentative at best and does not apply to low-inflation advanced economies (e.g. Catao and Terrones 2005). Indeed, substantial increases in public debt and deficit levels have not led to an 'outbreak of inflation' in the eurozone overall, although inflation rates for Greece in 2010 climbed to 4.7 per cent (ECB 2011).

Since 2008, the ECB has found itself at the centre of crisis policies with clear implications for its cherished independence, particularly in light of the Sovereign Debt Crisis that brought about subsequent interventions in the secondary bond market and participation in the troika rescue team for countries in financial distress<sup>32</sup>. This begs the question of whether independence for a monetary authority is desirable. While a final verdict on the desirability of central bank independence is inherently political by nature, economists have sought to answer this question by looking at the welfare/efficiency implications of coordinated monetary and fiscal policies, that is to say, the interdependent interaction between both policy areas (e.g. Wyplosz 2002). Von Hagen and Mundschenk (2001: 135) argue that 'ignoring the interdependencies between monetary and fiscal policies in the short run might lead to an unsatisfactory macroeconomic performance of the monetary union'. In analysing policies in the short run, the authors find a potential conflict between monetary and fiscal policies, which together shape aggregate demand in a monetary union. In a

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<sup>32</sup> The troika consists of representatives of the European Commission, the ECB and the IMF. Together they are responsible for deciding on a country's financial requirements if it has asked for financial assistance as well as for the supervision of the borrowing conditions. With regards to the latter, the troika assesses the implementation of structural reforms agreed upon in the Memorandum of understanding, signed by the parties receiving assistance.

scenario where the central bank strictly pursues its goal of price stability at the eurozone level, fiscal policy at the national level would lead to a purely distributional conflict. Any increase in the deficit levels in one country would crowd out demand in another. If these two governments were to then ignore this apparent conflict, both will increase government spending in an attempt to achieve a given output goal. However since aggregate output is controlled by the central bank, this fiscal expansion will merely result in higher interest rates in addition to larger debt levels with neither government achieving their output goal. Without explicit policy coordination between the ECB and Member States, governments and the central bank would compete in setting aggregate output in a monetary union. Hence policy coordination between monetary and fiscal authorities would be able to reach a better policy mix with lower interest rates and deficit levels. The authors then extend this argument to the case of an exogenous shock to aggregate demand in the monetary union, much like the Great Recession. Under exceptional circumstances of large shocks, so the argument runs, ‘adjustments in fiscal and monetary policies would be the result of co-operative agreements on policies, aiming at acceptable output-inflation combinations at the aggregate level’ (*ibid.*). This case for coordination in the face of policy interdependence makes for a strong defence for the central bank tolerating deviations from the mantra of price stability in times of crisis as it has during the past years by keeping interest rates low and further stimulating demand and stabilising public finances by ‘unconventional’ methods<sup>33</sup>.

Post-Sovereign Debt Crisis, the danger of stability free-riding was again formulated in terms of the presumed inflation-deficit linkage, yet the crisis-driven deterioration in public finances has not lead to inflationary pressures. More importantly, the ECB interventions were, with the notable exception of Greece, not necessitated by ‘excessive’ spending of national policy-makers and a failure to coordinate public finances, but by fundamental weaknesses in the banking sector: ‘The financial-fiscal

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<sup>33</sup> For a review and evaluation of the ECB’s crisis policies see Bini Smaghi (2009); Lenza *et al.* (2010) and Drudi *et al.* (2012).

feedback loop, not a weak and broken Stability Pact, has proven to be the Achilles heel for independent monetary policy' (Schelkle 2012a: 29).

### **Free-riding: growth and stability**

The free-riding problem applies, albeit to differing degrees, to all 27 EU Member States. The starting point is the existence of cross-border leakages. Member States with less expansive crisis responses can easily benefit from the externally generated expansion of demand without having to infer the high costs of budget deficits. Prior to the Great Recession, policy interdependence had already been seen to lead national policy makers to consider one another's fiscal policies when setting their own domestic plans. Analysing the time span of 1965 to 2003, Beetsma *et al.* (2006) demonstrate that a German fiscal expansion has quite strong effects on its smaller neighbours; an increase in public spending by 1 per cent of GDP in Germany leads to a more than 0.4 per cent normalised increase in GDP of Austria, Belgium and the Netherlands after two years, – while the corresponding number for Greece is only a 0.06 per cent increase in GDP. Moreover, the authors show that the planned average fiscal stance of EU partner countries influences an individual country's fiscal stance. In a related study, Giuliadori and Beetsma (2008) investigate the interdependence between deficits in the EU using an empirical analysis based on real-time fiscal data; a relaxation (tightening) of the planned fiscal stance elsewhere in the union leads an individual EU member to relax (tighten) its own planned fiscal stance. The authors explain this finding by pointing to direct externalities resulting from cross-border public investments, tax competition and peer pressure among governments.

Although empirical studies provide ample evidence for the existence of fiscal competition in the EU (e.g. Mintz and Tulkens 1986; Oates 2001; Baicker 2005; Kammass 2001), fiscal policy coordination is predominately concerned with securing sound government finances. This limits its interpretation of what constitutes 'good' fiscal policy to low deficit and debt levels, despite various policy dialogues that

specifically address wages and taxation. The SGP's preoccupation with deficits and debts has taken for granted that fiscal discipline is a legitimate collective concern. Prior to the Great Recession, free-riding was considered predominantly a matter of overly expansive fiscal policies. The phenomenon of fiscal free-riding (excessive deficits) in the eurozone had been warned of even before the introduction of the euro (Inman and Rubinfeld 1991; Portes 1993), analysed after stage III of EMU (Chari and Kehone 2007; Bonati and Crisitini 2008) and revisited during the current economic and financial crisis (De Grauwe and Moesen 2009). Although allegations of 'beggar thy neighbour policies', i.e. too restrictive fiscal stances, are not an entirely new feature of post-crisis debates (Dullien and Fritzsche 2006; Gros and Belke 2007), the Great Recession has put macroeconomic imbalances on the political agenda. This is not only a EU but also a global trend in international macroeconomic policy coordination. As Jones (2009: 61) argues:

'The argument is that [...] surplus countries have fostered the crisis through their single-minded determination to pursue export-led growth. [...] The time has come to reconsider the wisdom of export-led growth strategies both in the developing world and elsewhere. If accepted, these arguments will have important implications for how the world economy is reformed.'

Within EU fiscal policy coordination, free-riding during the Great Recession explicitly encompassed two kinds of behaviour. The first considers to the problem of excessive deficits and the danger of threatening the stability of EMU whilst the latter refers to a Member State implementing no or limited stimulus policies and due to trade linkages, being able to free-ride on the expansive fiscal policies of other Member States.<sup>34</sup> The basic rationale for fiscal policy coordination is therefore that it provides a mechanism to internalise externalities arising from the spillover effects that still hold in time of crisis. However in times of crisis these externalities are potentially bigger due to the increased scope for government action. Indeed, regarding the economic context under which fiscal coordination would be mutually

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<sup>34</sup> By differentiating between growth ('too little') and stability ('too much') free-riding of stimulus policies, I do not wish to suggest that austerity politics could not have a negative impact on the stability of EMU.

beneficial, Buti and Sapir (1998: 150) argue that only ‘in cases of severe common shocks or imbalances there may be a role for jointly agreed and announced budgetary policy actions.’ With monetary policy no longer a part of the official toolbox for national policy-makers, fiscal policy has gained importance as an instrument for macroeconomic management. The main cost of monetary union has generally been viewed as the loss of a key instrument of national demand management, domestic monetary policy, and of the associated ability to adjust exchange rates. Furthermore, as has been empirically confirmed, discretionary fiscal policy displays an asymmetry (Ardy *et al.* 2006: 38f.). In other words deficits expand further in downturns than they become surpluses in upturns. This deficit bias is likely to increase during the Great Recession when discretionary fiscal policy was used on an unprecedented scale.

Again, the first type of free-riding consists of ‘too little’ fiscal expansion in response to the Great Recession. Policy responses can gain efficiency if coordinated. Simply put, the stimulus programme in one country is likely to also stimulate other economies. In order for this effect to be optimal, a Member State should coordinate its fiscal stimulus with others. The apparent danger lies in the fact that other EU countries can easily benefit from the externally generated expansion of demand, without having to incur the high costs of budget deficits. In the presence of positive spillovers arising from stimulus programmes, the absence of coordination will lead Member States to refrain from undertaking fiscal efforts to stimulate their economies as they all have an incentive to free-ride, as was the case in the 1970s (de Grauwe 2009). A similar logic applies to the cost-benefit analysis when facing fiscal exit



strategies.<sup>35</sup> In the context of macroeconomic policy, ‘exit strategy’ refers to the withdrawal of economic stimulus programmes and a return to sound public finances through comprehensive consolidation strategies, with a strong focus on expenditure reforms (ECB 2009). Once one Member State starts the process of fiscal contraction, this will not only curb economic activity on a domestic level but also create negative spillovers in other states (see In’t Veld 2013). Whereas the initial benefit of a return to sound fiscal principles is enjoyed only by the first Member State, the costs of consolidation are accrued by other states as well. The likely reaction of other states is to follow the fiscal exit strategy, which will further reduce economic activity. This reduction could offset the positive effects on budget deficits. Non-coordinated exit strategies could therefore potentially hamper the recovery across national borders.

The second, and pre-2008 dominating, type of free-riding, stability free-riding, considers the hazard of too much fiscal expansion. EMU Member States have a vested interest in coordinated fiscal policy in order to secure fiscal stability.

Analogous to growth free-riding, one can easily imagine a scenario where one Member State engages in more discretionary spending than would be advisable with respect to its fiscal space, knowing that other Member States will exercise sufficient fiscal constraint for inflation and interest rates, as well as corresponding ECB policies, to not react. In other words, Member States feel sheltered from punishment normally resulting from imprudent fiscal behaviour. Likewise a Member State might prefer to push its fiscal consolidation back to a politically/economically more auspicious date, hoping that other Member States provide sufficiently stabilising policies for the Eurozone as a whole. The problem presented by over-stimulating in

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<sup>35</sup> The term ‘exit strategy’ entered the political discourse in the 1980s and was predominately used to describe tactics to withdraw troops from war-zones (Safire 1995). Prior to the Great Recession, the term was used in various EU communications referring to disaster relief and emergency assistance, as well as humanitarian crises in Kosovo and Somalia. The macroeconomic application of exit strategy entered the EU public policy jargon in the spring of 2009, both with respect to monetary and fiscal policy. Officially, Ministers agreed on the need for a co-ordinated and comprehensive approach on exit strategies at the Informal Ecofin in Gothenburg on the 20<sup>th</sup> October 2009 (European Commission 2010).

the context of fiscal policy has been analysed more generally by Hardin (1968: 1244) who describes how shepherds sharing common pasture overgrazed since they were 'locked into a system that compels (each one) to increase his herd without limit'.

Stability free-riding (stimulating 'too much') is related to the problem of moral hazard. For EMU Member States, moral hazard is often evoked with respect to the No-Bail-Out Clause found in Art. 125 of the TEU, which seeks to strengthen the case in favour of fiscal policy coordination and prevent Member States from free-riding and thus to avoid moral hazard. It essentially states that neither the Community nor any Member State can be liable for the commitments of other Member States. This provision does not only prohibit the assumption of a Member State's debt, but it also prohibits EU liability for such commitments: 'The Union shall not be liable for or assume the commitments of central governments.' This clause is only one of a number of institutional arrangements for sound fiscal policies at the EU level. It should be seen as complementary to the prohibition of monetary financing (Article 123 of the Treaty on the Functioning of the European Union), the prohibition of privileged access to financial institutions (Article 124 of the Treaty), the SGP and the fiscal provision to avoid excessive government deficits (Article 126 of the Treaty) and the no-inflationary bail-out obligation of the ECB (that is the Central Bank accepting a higher level of inflation than warranted). In times of crisis the No-Bail-Out clause is thought to caution governments not to spend beyond their means. It is hence an additional commitment device (in the shape of a non-commitment) to avoid moral hazard problems.

Yet, with the heightened economic and political turmoil of the Sovereign Debt Crisis, European policy-makers were caught between the Scylla of moral hazard and the Charybdis of contagion. The former arises because bailing out a fiscally wayward state might send a signal that irresponsible macroeconomic management will not be punished, whilst the second stems from the risk of contagion both for the weaker Member States at the periphery as well as within the European banking system.

Subnational government defaults regularly involve large externalities on the rest of the federation or a specific group of the other Member States of a monetary union, which render it undesirable for the other states or the central government to deny a bailout (e.g. von Hagen *et al.* 2000). The introduction of a single currency, the abolition of capital controls and the Single Market programme for financial services, has led European investor portfolios to become increasingly diversified.

Warnings that a bailout of one Member State would become increasingly likely have been heard since the early 1990's (Bovenberg *et al.* 1991). The apparent policy dilemma posed by the high costs of actually sticking to Art. 125 gives further rise to the call for fiscal policy coordination as a means to avoid any excessive debt situation in which a bailout might become inevitable.

Although the concern of fiscal unsustainability is more pronounced within a monetary union, countries outside the Eurozone also have reason to participate in fiscal policy coordination. First, the impact of economic crisis is felt by other integrated economies. The EU Treaty considers economic policies a 'common concern' for all, not just eurozone, EU countries. Accordingly, the externalities of economic fallout are felt throughout the EU. Secondly, the financial assistance to Member States, that is the feared bailout, can be provided to and by EU members outside the eurozone as well. Ultimately, fiscal policy coordination is thus thought of as a means to prevent the need for financial assistance.

### **The case against fiscal policy coordination**

The marked push for greater fiscal policy coordination and the perceived need to reform EU economic governance in the wake of the Sovereign Debt Crisis tend to conceal the fact that there are reasons against fiscal policy coordination both on political as well as economic grounds. The two most common objections to fiscal policy coordination are based on considerations of efficiency and legitimacy.

## Efficiency

The criticisms against fiscal policy coordination find negative responses to the question of whether there are benefits arising from collective action, i.e. benefits for the union as a whole and also for individual Member States. One argument against fiscal policy coordination is that it would not be worth the trouble, as the spill-over affecting the central monetary policy and the fiscal policies of other EMU Member States is at least in ‘normal’ times too small (e.g. Eichengreen 1997; Buti and Sapir 1998). More recent studies have further highlighted that the cross-border effects of tax and government spending shocks are weak and/or insignificant in EMU. As such the size of national fiscal multipliers<sup>36</sup>, and as a consequence the quantitative influence of a spill-over effect, will be limited (Gros and Hobza 2001; Benassy-Quere and Cimadomo 2006; Marcellino 2006). Dixit and Lambertini (2003) for example, show that the targeted output and inflation goals can be met with or without fiscal coordination, and what is more, that the SGP is not a necessary instrument to achieve those objectives. It is argued that it would therefore make little economic sense for national policy-makers to jointly decide on their fiscal policies.

The question remains whether the coordination of fiscal stimulus measures would reduce cross-border leakage and therefore contribute to the efficiency of a national fiscal stimulus programme in the light of a common negative shock of the magnitude of the Great Recession. Beetsma *et al.* (2001) provide evidence that fiscal coordination is most likely to be desirable when the European economy is hit by asymmetric (demand or supply) disturbances, when the correlation of the shocks hitting the various economies is low. In that case the scope for fiscal coordination is larger, because the ECB remains passive as average inflation in the union is unaffected. It is however difficult to establish whether the Great Recession should be considered a symmetric or asymmetric shock. The European Commission (2009) has

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<sup>36</sup> The fiscal multiplier refers to the ratio of a change in output to a change in the fiscal deficit with respect to their respective baselines (Eyraud and Weber 2013).

dodged such a definition by calling it a ‘symmetric shock with asymmetric implications’. Following Beetsma *et al.* (2001), one of the main criteria for the evaluation of fiscal coordination efficiency is the reaction of the ECB. Since the ECB has pursued a course of – in its short history unprecedented – loose, growth-friendly monetary policy, one could argue that it is irrelevant whether the crisis was asymmetric or not in the absence of ‘harmful’ ECB interventionism. It seems that the ECB has suspended its policy of ‘strategic substitution’ (Melitz 1997) according to which monetary and fiscal policies move in opposite directions, in times of crisis.

Whilst this strand of criticism has addressed the benefits/externalities for the EU as a whole, the vast majority of literature criticising the existing fiscal policy framework has focused on the impact of such coordination on individual Member States’ economies. Firstly, the fiscal strictures under the SGP are often presented as detrimental to structural reforms. Fiscal rules imposing annual ceilings on the government deficit and/or debt ratio, it is argued, may give disproportionate priority to short-run fiscal discipline at the cost of long-run economic growth and even long-run fiscal sustainability. This is because reforms are discouraged, as their associated budgetary costs would risk breaching the SGP (e.g. Eichengreen and Wyplosz 1998; Razin and Sadka 2002; Beetsam and Debrun 2005). Secondly, the fiscal policy coordination mechanism in place is said to pose an obstacle to the stabilisation function of fiscal policy. Since monetary union has removed the ability to set country specific interest rates, the government’s capacity in fiscal stabilisation should not be restricted (Schelkle 2005: 372). In a similar vein, Calmfors (2003) stresses that the SGP may increase output volatility because it hampers stabilisation efforts in downswings. This argument is contested, however. Lifting (2000) argues that the deficit ceiling of the SGP increases the effectiveness of fiscal policy as a stabilisation tool, because EU states with lower debt levels have a better record in stabilising their economies. In addition and contrary to Schelkle (2005), Buti(2000) for example, argues that by creating deficit restrictions the Pact would create fiscal room for manoeuvre for Member States to smooth out economic shocks. Similarly, it has been

argued that the SGP would not guarantee a sufficiently balanced policy mix and would leave inadequate room for fiscal policy to support economic growth (e.g. Fitoussi 2002; Bofinger 2003). In the context of the economic and financial crisis, both the stabilisation and growth-supporting roles of fiscal policy are considered necessary. Whilst these accounts attack fiscal policy coordination from different angles, all are highly critical of the underlying economic rationale for such collective action.

### **Legitimacy**

In a key work on the political consequences of increasing economic interdependence, Cooper (1968) identifies various obstacles to successful economic policy coordination. Firstly, even if like-minded countries agree on broad principles (i.e. in the case of EMU the paradigm of low inflation and sound public finances), that is to say they operate within the same broad conceptual framework, the challenge remains to strike the right balance of macroeconomic management. Countries are likely to have different policy preferences and in order for a policy to be legitimate, policy-makers have to take the tastes of their constituency into account. Given this difference in national policy preferences, Alesina and Wacziarg (1998: 3) consider that it was ‘unclear why [...] European countries should agree on economic and non-economic policy issues, even though they do not share a common language, common interests, and common histories’. Secondly, variation in policy taste is likely to increase further in times of crisis, when old systems of economic beliefs are called into question and the forecast of future events, ‘either with respect to the course of events without changes in policy or with respect to the influence of policy action on the targeted variables’ (Cooper 1986: 1228), is marked by uncertainty. That is to say, policy makers are more likely to disagree on the structure of the economy and consequently on the association of means and ends. Collignon (2003) doubts whether the existing rules for fiscal policy-making in the EU reflect the ‘policy tastes’ of Member States. He does not see the degree of binding obligation as the main

problem of the SGP but rather its lack of democratic legitimacy. ‘Hard budget constraints for fiscal authorities are a necessary condition for macroeconomic stability, but such institutional rules are only sustainable if they are backed by collective acceptance, expressed in the democratic choices of European citizens’ (*ibid.* 244).

Further legitimacy arguments are associated with proponents of fiscal federalism.<sup>37</sup> Regional diversity of choices concerning the conduct of fiscal policy suggests that a local, rather than a central, jurisdiction should be entrusted with the production of fiscal policy (Olson 1969). The same reasoning can be applied to the national versus supranational level, which mirrors the democratic deficit claim about EMU more broadly (Verdun 2000a; McNamara and Meunier 2002; Jones 2009; Verdun and Enderlein 2009; Majone 2010) and the ECB specifically (Buiter 1999; Taylor 2000; Howarth and Loedel 2005: ch.4). Fiscal federalists overwhelmingly argue that there are no compelling arguments for a common monetary union to also require fiscal union and an accompanying shift in decision-making power from national/regional to Community authorities (von Hagen 2006). This argument follows the logic of subsidiarity, i.e. the respect for local/national control wherever feasible which is considered to weigh heavier than any advantages gained from having a centralised fiscal policy (Ardy *et al.* 2006: 95). Cooper (1968) names the strong public sentiment in favour of the preservation of national freedom of action, despite the forces of policy interdependence being one of the main barriers for the coordination of economic policy: ‘The illusion of national autonomy is still widespread and is widely confused with national sovereignty’ (*ibid.* 1229). With the reform of fiscal policy coordination in the aftermath of the Sovereign Debt Crisis and the strict constraints on fiscal policy making for those countries that requested financial assistance, debate

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<sup>37</sup> Hallerberg (2011) presents fiscal federalism modeled after the Brazilian system, as one of two feasible solutions to reform the EU’s framework. More integration under fiscal federalism, so the argument goes, would be able to prevent a situation where a bailout would become an option.

on the legitimacy of fiscal policy coordination has once more taken centre stage (e.g. Hallerberg *et al.* 2012; Crum 2013; Torres 2013).

## **Conclusion**

The theme running through this chapter is that the interdependence of EU economies requires co-operative solutions to common problems. Unilateral action is likely to result in negative spill-over effects for other Member States and, in a worst case scenario, might be detrimental to fiscal stability. Fiscal policy is treated as a matter of common concern and its coordination thus emerges as a means to achieve outcomes in a more efficient and more optimal manner. This is particularly true for EMU Member States that share a common monetary policy. As the two objections against fiscal policy coordination outlined above have highlighted, the appeal of and necessity for the centralised coordination of national public finances is far from uncontested. Fiscal policy coordination should be considered neither a panacea to the EU's current woes, nor as equally desirable to all EU Member States. In fact, one of the many obstacles to successful collective action is that Member States have different preferences about the design and form of fiscal policy and its coordination in light of asymmetrical policy interdependence.

Prior to the outbreak of the economic and financial crisis and post Sovereign Debt Crisis, the dominating reason for fiscal policy coordination was identified in stability free-riding, culminating in ECB and/or Member State bailout. This changed during the Great Recession when the economic downturn brought about the coordination of stimulus packages and consequently concerns over growth free-riding, to the top of the EU's fiscal policy agenda. The past crises have revealed fundamental flaws with the conceptionalisation of fiscal policy coordination and the single-minded focus of respecting the SGP criteria (stability free-riding). The focus on fiscal profligacy as the main source of fiscal risk is misleading; with the exception of Greece, Member States who were in need of financial assistance had not run large deficits and debt



levels were considered sustainable prior to 2008. By focusing on the prevention of moral hazard (in the form of No-Bail-Out Rules and the SGP), the existing framework was neglectful of the systemic risk stemming from the financial sector. The sharp deterioration in public finances was then not a result of policy-makers prone to run deficits to curry electoral favours, but a result of 'sizeable fiscal costs through a combination of financial sector rescues, forfeited revenues owing to depressed activity and, more secondarily, discretionary counter-cyclical fiscal impulse to lessen the downturn' (Buti and Carnot 2012: 903). What is more, the preoccupation with the prevention of free-riding lead to a coordination system that lacked provisions to allow for bailouts. The costs of sovereign default within the eurozone were considered to exceed the political (in terms of moral hazard) and economic costs of financial assistance in the face of substantial interdependence of the national financial system of all EU Member States. This omission ultimately threatened the stability of the eurozone much more than past breaches of the SGP.

## CHAPTER 3: ON THEORIES, METHODS AND HYPOTHESES

### Introduction

Over the course of the past decade, the study of European integration has seen an increase in literature championing a so-called eclectic approach (e.g. Stone Sweet *et al.* 2001; Rumford 2002; Ringe 2009), set out to defeat the credo of ‘parsimonious theorising’ (Hirschman 1986).<sup>38</sup> Research on EMU has been particularly affected by this development, as the very nature of the subject touches upon a myriad of economic, political and social aspects.<sup>39</sup> While for the most part these studies offer the expected advantage of providing comprehensive and inclusive explanations of the phenomena under investigation, they tend to fall flat with respect to hypotheses testing and often lack theoretical focus. Pounding the streets of the main theories of European integration (the ‘usual suspects’ being (liberal) intergovernmentalism, neo-functionalism, new institutionalism, and social constructivism), such studies may easily turn into textbook exercises of theory-catechism, whose conclusions read like the Dodo bird’s Caucus race where ‘everybody has won, and all must have prizes’ (Carroll 1992, 1865: 63). The arguments of this thesis are not limited to one theory and to borrow Hirschman’s (1981) description, ‘trespass’ on the grounds of various bodies of literature that unite under the umbrella of the political economy of policy coordination. In so doing, this thesis acknowledges the main pitfalls of aggregating theoretical approaches with conflicting epistemological premises. Given the slippery nature of defining coordination that Metcalfe (1988: 2) considered a ‘standing temptation to academic eclecticism’, such caution is particularly apposite.

The focus of this chapter is to discuss the conceptual framework, research hypotheses and methods used for examining fiscal policy coordination during the Great Recession. It starts by introducing the theoretical starting point of this research,

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<sup>38</sup> For a rejoinder to Hirschman see Gerring (1999).

<sup>39</sup> Here, particularly Dyson ed. (2002) comes to mind, which examines the impact of EMU on member states by applying a Europeanisation approach.

collective action theory. I then propose three main hypotheses considering the EU's latency, incentives for group-oriented behaviour and fiscal free-riding. These hypotheses will be tested in Chapters 5, 6, and 7 using a mixed-methods approach of qualitative and quantitative methods.

### **Collective action theory**

Since the 1980s, International Relations (IR) scholars have reinvigorated debates about the concept of international cooperation, discussing the constraints and opportunities for macroeconomic policy cooperation and coordination in the face of interdependence (e.g. Oye 1986; Bryant and Portes 1987; Dobson 1991; Kenen 1995). At the same time the discussion has been further stimulated by new institutional economics (Brousseau and Glachant 2008) and public choice theory (Mueller 2000). The focus of this thesis is policy coordination. As this is in many instances congruent with collective action, it should come as no surprise that the literature on the logic of collective action, particularly Olson's seminal work (1965), serves as this study's theoretical foundation.<sup>40</sup> The starting point of the logic of collective action in IR is the so-called moral hazard problem; policy-makers are prone to disregard the externalities of their policies for other states, and thus create non-optimal equilibria. Olson's work rests on the premise that individual rationality is not sufficient for collective rationality. He notably described how, due to the strong incentives to free-ride for each individual, a situation in which the benefits of a public good cannot be successfully limited to those that positively contribute to its generation causes this good to be provided at sub-optimal levels, if at all.

One of the key dependent variables in analysing collective action for Olson and other scholars of social dilemmas is the question of group size. Olson (1965: 48-49) argues that for a number of reasons, group size is negatively related to the likelihood of

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<sup>40</sup> Various scholars have analysed free-riding behaviour and selective incentive prior to Olson. But, as Dougherty (2001: 250) argues 'these ideas were not prominent. Most of these theories were hidden in a mass of written works that were totally disregarded until Olson gave them relevance again'.

providing collective goods. Firstly, the larger the group, the smaller the fraction of the total benefit any member acting in the group interest receives and thus the less adequate the reward for group-oriented action. Secondly, the larger the group, the smaller the likelihood of oligopolistic behaviour<sup>41</sup> that might help to provide the good. Finally, larger groups involve higher organisation costs and as such higher transaction costs are involved in agreeing on and maintaining a coordination strategy.

For the purposes of this study it is more useful to think of group *composition* instead of group size.<sup>42</sup> Key here are the characteristics of EU Member States and their impact on fiscal policy outcomes, not the number of group members *per se*. Group composition thus determines the size of the benefits that any individual member receives from the provision of the public good in relation to the costs of his contribution towards its provision. The analysis of costs and benefits is expressed by the public good's specific provision (costs) and allocation (benefits) function. Depending on group composition, Olson (1965: 50) distinguishes between three kinds of groups; privileged, intermediate, and latent groups. In a privileged group, 'each of its members, or at least some of them, has an incentive to see that the collective good is provided, even if it has to bear the full burden of providing it himself' (*ibid.*). Accordingly, a collective good may be provided even without any group organisation, coordination or additional incentives. In an intermediary group,

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<sup>41</sup> Oligopolistic action is group-oriented, coordinated action by a subgroup of members of a group towards the provision of a public good. Crucially the provision functions of stability and growth are variable. For example, prior to the economic and financial crisis, the overall stability (as indicated by sovereign bond spreads) was essentially a 'best shot' scenario with Member States (including now famously Greece) paying almost the same interest rates on government borrowing as Germany. De Grauwe and Ji (2013) argue that this convergence was driven by an implicit understanding that the bail-out agreement in EMU would not be enforced. This claim is echoed by Sara Bertin, then Greece analyst at Moody's, who argues that there was a widespread 'belief that Greece was now part of the Eurozone and that nobody was ever going to default' (*New York Times*, 29.11.2011). Yet at no point in time was pure oligopolistic provision of both public goods – stability and growth – possible. Even Germany, EMU's 'weak hegemon' (Eichengreen 1987), is not in a position to singlehandedly provide stability by 'maintaining liquidity, solvency and the political conditions for adjustment' but depends on the cooperation of other group members (Schelkle and Mabbett 2013: 2). Likewise Germany does not have the economic resources (even if the political conditions for such policies was somehow magically secured) to provide for growth throughout the EU.

<sup>42</sup> The notion that group size and collective action are negatively correlated has, since Olson's seminal account, been refuted by numerous studies (e.g. Hardin 1982: 41; Agrawal 2000, see also Poteete and Ostrom 2004).

‘no single member gets a share of the benefit sufficient to give him an incentive to provide the good himself, but the group does not have so many members that no one member will notice whether any other member is not helping to provide the collective good’ (*ibid.*). In an intermediate group, a collective good cannot be obtained without some level of group coordination. The third, the latent group ‘has no incentive to act to obtain a collective good because, however valuable the collective good might be to the group as a whole, it does not offer the individual any incentive to bear [...] any of the costs of the necessary collective action’ (*ibid.* 51). The greater the latency of a group, the lower the probabilities of a public good being provided and the greater the chances of collective action failure. The way out of the social dilemma for latent groups is the provision of separate and selective incentives that will ‘stimulate a rational individual in a latent group to act in a group oriented way’ (*ibid.*). The three main hypotheses of this thesis are developed systematically from Olson’s theory of collective action and consider group latency, separate and selective incentives and finally free-riding/collective action failure.

### **Bounded rationality**

This thesis works with a weak rationality assumption (e.g. Elster 1986, 2000).<sup>43</sup> In economics more generally, bounded rationality is linked to the assumption of finite limits to the amount of information the human brain can hold and process. Instead of optimising, that is to say considering all possible alternatives and choosing the best, individuals and organisations are said to consider only a limited set of alternatives and make a choice once they reach a tolerable course of action, known as satisficing. The understanding of bounded rationality used in this thesis goes further than the distinction between optimising and satisficing, which hinges on endogenous factors (cognitive constraints), instead considering the influence of exogenous factors as

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<sup>43</sup> Olson’s work (1965) introduces a variant of this theme distinguishing between individual and collective rationality. Accordingly individual rationality is said to be an insufficient condition for collective rationality.

well. In so doing, it follows Simon (1969), who argues that rationality resembled a pair of scissors where one blade is the ‘cognitive limitation’ of actual humans and the other the ‘structure of the environment’. State preferences for policies and institutions are considered to be not merely the pure product of rational reasoning, but contingent on political culture, ideology, rules and conventions. Fiscal-policy making is not merely a product of reconciling economic possibilities (i.e. the country’s fiscal space) with political strategies, but is further influenced by the societal consensus on the role of the state. For example, the initial German reluctance to stimulate the domestic economy in the autumn of 2008 seems irrational in light of its structural strength and fiscal space. A look at Germany’s peculiar relationship with fiscal policy explains the initial hesitance and subsequent poor communication strategy in which the government has effectively undermined its own stimulus efforts in front of European partners. Conversely, the Spanish governments’ overly generous stimulus programme cannot be explained by examining the economic situation of the country but was rather the result of deliberate choices of policy-makers in times of crisis who, unaware of the fragility of the banking sector, pursued a policy of active demand management in an election period.

Note that bounded rationality should not be confused with irrationality. As Drazen (2001: 410) concludes:

‘a goal of political economy is to show how policies which seem suboptimal (hence, irrational in terms of basic welfare economics) can in fact be shown to be the result of the political mechanisms under which the decisions of rational, self-interested agents are agreed’.

The rationality of collective action depends on the specific parameters of a situation with the specific function describing the costs of the public good, its value to individual group members and the probability that the good will be provided without his or her individual contribution. Explaining collective action (failure) is hence also an attempt to explain the seemingly irrational state of policy (non-) coordination and to present it as the ‘rational’ outcome of individual optimisation/satisfying, contingent on intervening factors.

## Research Hypotheses

In this section I formulate the independent variables that are used to explore the three main hypotheses of this study. Three main elements of Olson's theory guide this study and inform the three-step testing design; this is outlined in Figure 3.1. In a first step, I examine whether EU Member States can be characterised as a latent group in terms of fiscal policy choices. Specifically, by identifying the determinants of fiscal policy choices I am able to draw inference on group latency. If group latency is found to be a problem, Olson suggests the need for incentives to motivate group members to contribute to the production of the collective good in question. Hence in a second step, I examine the working of different separate and selective incentives and whether or not they matter for public finances in times of crises. Weak incentives, in turn, would imply a high likelihood of free-riding behaviour/collective action failure. The third hypothesis therefore considers evidence in favour of or against stability and growth free-riding during the Great Recession.

*Insert Figure 3.1. here*

### Latency Hypothesis

There is no latency litmus test yielding yes or no answers. The use of latency is a conceptual device. To test for group latency in EU fiscal policy coordination, I will first examine the determinants of fiscal policy outcomes, which in turn either contribute or fail to contribute to the public goods defined in Chapter 2 (i.e. stability and growth). The first hypotheses tested in this thesis are that

*H1a: Fiscal policy coordination in the EU takes place in a latent group between 2008-2010.*

*H1b: Fiscal policy coordination in the EU does not take place in a latent group between 2008-2010.*

Latency is not equivalent to heterogeneity *per se*. On the one hand a group may be highly heterogeneous, that is diverse in character or content, but still classify as a salient group, for instance via the oligopolistic provision of the public good. On the other hand a highly homogeneous group might still be a latent group, for instance if all group members care little about the provision of a public good and are also united by a belief that their non-contribution to its production will remain unnoticed. The term latency originates in physics where it describes the delay between the receipt of a stimulus by a sensory nerve and the response to it. Following this image, latent EU Member States, depending on their propensity to contribute to fiscal policy coordination, delay, maladapt or ignore their policy responses to the Great Recession.

It is possible to model latency as a function of the economic and political environment of fiscal policy-making. Following the distinction between heterogeneity and latency, the fact that Member States experienced the crisis very differently, or the fact that national policy-makers operate in dissimilar political systems do not suffice to establish group latency. In order to do so, it is necessary to first test whether these heterogeneous variables have an impact on fiscal policy outcomes during the Great Recession. Building on the theoretical considerations and empirical findings of the existing literature, one can identify the political factors that are likely to impact on a state's fiscal response to the financial and economic crisis and by proxy to influence its contribution to fiscal policy coordination. Likely determinants of public spending are presented as sub-hypotheses of the latency hypothesis below. Given the heterogeneous political landscape of EU Member States that have differing electoral calendars, partisan outlooks, executive and legislative makeups, fiscal policy outcomes are likely to be heterogeneous across Member States. In order to ascertain whether this group heterogeneity influenced the group latency, I will first establish whether these factors indeed influenced fiscal crisis responses.



## **Determinants of fiscal policy**

To explore the latency of the eurozone Member States, I focus on four groups of political variables inspired by the literature on the deficit and debt bias of public finances. In doing so I include not only the literature on fiscal expansion, but consider also the literature on fiscal consolidation. The inclusion of these studies is relevant for two reasons; consolidation is simply the flipside of stimulus policies and efforts (in most cases alongside stimulus policies) had already started in 2009 and 2010, Estonia, Greece and Ireland in particular, to implement substantial consolidation measures (Public Finances in EMU 2010: 20). I first examine the impact of the political business cycle (PBC). Secondly, I analyse the strength of the executive branch. Third, I analyse the strength of the opposition before finally turning attention to the political colour of government.

### ***Political business cycle***

One of the central hypotheses of the political economy of public deficits revolves around the PBC, based on the premise that policy-makers are opportunistic and voters myopic. Consequently, the central aim of public policy is to secure re-election. Assuming that the expected support for a party will rise with the short-term welfare it delivers, deficits are higher in election years when incumbent governments try to buy electoral support (Nordhaus 1975). A myriad of studies have been developed since the 1970s (for an overview see Drazen *et al.* 2001), forming a body of literature that although theoretically rich and empirically sophisticated, is far from uniform in presenting evidence concerning the impact of elections on public finances.<sup>44</sup> Studying the impact of elections on public finances in EMU, Buti and van den Noord (2003), von Hagen (2003), Hallerberg *et al.* (2009: ch.4) and Mink and de Haan (2006) present evidence of expansionary fiscal policies in EU member countries before elections, despite the introduction of the SGP. Other studies have however

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<sup>44</sup> See for instance Schuknecht 1996; Block 2002; Brender and Drazen 2005; Shi and Svensson 2006.

cast doubt on the presence and/or strength of a PBC in EMU (e.g. LeMay-Boucher and Rommerskirchen 2014). A subgroup of the PBC literature has explored the relationship between fiscal consolidation and elections; Whilst Lavigne (2010) shows that elections do not matter for fiscal adjustments in advanced economies a number of studies have argued otherwise. Gupta *et al.* (2005), for example, find that fiscal consolidation is less likely to occur during election years than during non-election years; Mierau *et al.* (2007) analyse 20 OECD countries for the period 1970-2003 and similarly argue that the likelihood that a rapid consolidation takes place is negatively influenced by upcoming elections. Based on these studies, it is fair to say that fiscal policy may indeed be more expansionary in election years.

### ***Political fragmentation***

Political scientists and economists have argued that budget deficits are more likely in countries with fragmented executive or legislative polities. The former, in particular, has received much attention in the literature. Fiscal policy under coalition or fragmented governments<sup>45</sup> is said to suffer from a so-called ‘common pool problem’ (see Weingast *et al.* 1981, Velasco 1999). This problem arises because for a typical spending programme, the costs are spread over a larger group with benefits being concentrated in a smaller group. The resulting ‘overgrazing’ of the common pasture (Hardin 1982) then leads to a deficit and debt bias.<sup>46</sup> Hallerberg and von Hagen (1999) empirically show that the members of a given government coalition prefer to keep taxes low on their own constituencies, thus contributing to the deficit bias. In a similar vein, Persson *et al.* (2003) argue that each member of the coalition will support initiatives to increase spending on items favouring their own

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<sup>45</sup> Government fragmentation usually distinguishes between the minority/majority governments and the number of parties in the coalition.

<sup>46</sup> More specifically Hardin (1968) described ‘the law of 1/n’, according to which the larger the number of graziers (the n) on the budgetary commons, the smaller is the fraction of costs that each grazer internalises. The severity of the common-pool problem increases the smaller the fraction of the total cost that each grazer has to take on, the smaller become the perceived costs compared with the actual costs.

constituencies. Excessive spending is then positively related to the different groups/constituencies represented by the government<sup>47</sup>. A different perspective on government/coalition fragmentation frequently cited in the literature explores the impact of spending ministers. Wehner (2011) argues that because the most important representatives of individual spending preferences in European governments are the individual spending ministers, public spending is positively related to the number of spending departments and ministers in a country's government. This proposition is empirically confirmed for OECD countries by *inter alia* Kontopoulos and Perotti (1999) and Volkerink and de Haan (2001).<sup>48</sup>

Turning to the question of fiscal consolidation, Alesina and Drazen (1991) show that the persistence of large deficits may be due to inefficient political equilibria, in which coalition members are unable to agree on a consolidation package. The implication of this 'war of attrition' model is that the higher the degree of heterogeneity of government coalitions, the higher the likelihood that consolidations are delayed. Studying 15 EU Member States between 1960-2000, Maroto and Mulas-Granados (2002) find that the higher the number of spending ministers in the cabinet, the higher the number of accumulated failures to consolidate, and during election years, the higher the probability that the fiscal consolidation ends and a fiscal expansion begins. Support for the hypothesis linking the failure of fiscal adjustment to government fragmentation is mixed.<sup>49</sup>

Fragmentation in the legislature is likewise thought to increase deficits. In fragmented legislative systems, so the argument goes, each party has an incentive to secure as much spending as possible to its political constituents (Mukherjee 2003). Crepaz and Moser (2004: 271) advocate the inclusion of the 'effective number' of parties in the parliament rather than the number of parties in the governing coalition,

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<sup>47</sup> See also Tsebelis 1999; Hallerberg and Basinger 1998; Tsebelis and Chang 200; Lane 2003.

<sup>48</sup> For further empirical tests of this hypothesis see Balassone and Giordano 2001; Harrinvirta and Mattila 2001; Mulas-Granados 2003.

<sup>49</sup> See *inter alia* Edin and Ohlsson 1991; Alesina and Perotti 1995; De Haan *et al.* 1999.

to fully consider the effects of the number of veto players in the budgetary process. Other studies have focused on the fragmentation of the legislative opposition in relation to the fragmentation of government (e.g. Ricciuti 2004). To summarise, I expect both government and opposition fragmentation to have a positive impact on the size of the fiscal stimulus.

### ***Partisan politics***

A fourth determinant of fiscal outcomes frequently tested in the literature is ideology. The analysis of the impact of political parties and their ideological inclinations has been the target of considerable scrutiny since the early 1970s. Proponents of the left-right hypothesis regarding public deficits argue for a causal relation between political variables and policy outputs (e.g. Hibbs 1977: 485). A myriad of studies since then have examined the impact of (different) ideological stances within the executive (e.g. Mink and de Haan 2006) and legislative branches (e.g. Heller 1997). Various studies have found evidence for increased budget deficits under left-wing parties (De Haan and Sturm 1997; Imbeau *et al.* 2001), whilst others find no relationship between the party/parties in power and government spending (e.g. Pampel and Williamson 1988). Similarly, it is argued that the ideological positioning of government matters for the implementation of fiscal consolidation (e.g. Alesina and Perotti 1995; Mulas-Granados 2003). Reviewing the literature, Clark (2003: 49) concludes that the evidence for the ‘Hibbsian relationship between fiscal policy and the ideological orientation of the government is mixed at best’. Following the conventional assumption that a left-wing deficit bias is in part due to a propensity to implement Keynesian demand policy, it can be argued that this bias, if it exists at all in the contemporary EU, should be amplified in times of economic crisis when the perceived need (and therefore justification) for fiscal intervention is stronger. This would suggest a positive relationship between the size of stimulus policies and left-wing governments, whereas the association between left-leaning parties and fiscal consolidation is likely to be negative.

## Incentives hypothesis

Group latency creates necessary but not sufficient conditions for the failure of collective action. In other words, free-riding behaviour is not an inevitable policy outcome for latent groups. To overcome free-riding and non-group oriented behaviour in latent groups, Olson (1965: 51) argues for the utilisation of separate and selective incentives to stimulate cooperation. Notably, incentives should not work indiscriminately like the promise of a collective good, but rather be targeted selectively towards the individual in the group.<sup>50</sup> Negative incentives are defined as punishments that leave an individual on a lower indifference curve than she would have been had she contributed her share of the cost towards the provision of the collective good. Positive incentives, on the other hand, are defined to be any reward that leaves an individual on a higher indifference curve and thus makes group-oriented behaviour more appealing<sup>51</sup> (e.g. Kuhn 1963: 365-370). These incentives can then mobilise latent groups into collective action by altering the cost-benefit calculus of individual members. Following Olson's (1965) argument, the rival hypotheses tested in chapter six are:

*H2a: Free-riding was kept at bay due to select and separate incentives between 2008-2010.*

*H2b: Free-riding was not reined in by select and separate incentives between 2008-2010.*

## Separate and selective incentives in fiscal policy coordination

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<sup>50</sup> In their extreme form these incentives can take the form of coercion. In Chapter Three of *The Logic of Collective Action*, Olson (1965) argues that coercion is necessary for union survival. The legal obligation of (some) workers to join unions as well as the negative consequences of not joining exceed by far the possible ramification surrounding the compliance with EU's fiscal rules which hardly qualify as 'coercion', regardless of the definition used.

<sup>51</sup> In microeconomic theory, an indifference curve is a graph showing different bundles of goods, or in the case of fiscal policy actions, between which an actor is indifferent. At each point on the curve, she has no preference for one bundle over another.

In order to explore their role in the success or failure of fiscal policy coordination I focus on two kinds of incentives. I first examine the impact of fiscal rules on stimulus policies, distinguishing between domestic and EU rules. Secondly, I analyse the role of financial market participants, specifically the impact of bond yields, in driving fiscal expansion.

### ***Fiscal rules***

A fiscal rule can be defined as ‘[a] permanent constraint on fiscal policy, typically defined in terms of an indicator of overall fiscal performance’ (Kopits and Symansky 1998: 2). The literature on fiscal rules highlights the importance of institutions which, according to Hall’s influential characterisation (1986: 19), are defined as ‘the formal rules, compliance procedures, and standard operating practices that structure the relationship between individuals in various units of the polity and economy’. Different institutions (fiscal rules) therefore provide the framework within which individuals and groups define their preferences and thereby shape the strategic choices of policy actors (e.g. Shepsle 1989; March and Olsen 1996; North 1990). The theory of collective action is closely linked to the study of institutions, as these are considered to be the preferred loci of overcoming social dilemma. Ostrom (quoted in Peters 2005: 52) stresses that cooperation is most efficient if institutionalised, because institutions are a means to ‘prescribe, proscribe, and permit’ behaviour.<sup>52</sup>

In analysing the impact of EU fiscal rules, the evidence for a disciplinary effect is mixed. Afonso and Hauptmeier (2009) show that for the 1990-2005 period, both the rules laid out in the Maastricht Treaty and in the SGP have a statistically significant

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<sup>52</sup> In a similar vein, Shepsle (1989) argued that institutions are an attempt to solve the ‘Arrow Problem’ of how groups can make decisions that satisfy the conditions of a social welfare function without having the decision enforced through hierarchical coercion.

positive effect on the improvement of the fiscal position and suggest that this is due to an increased effort pursued by the EU countries to comply with the existing EU fiscal framework; similar evidence is presented by Busemeyer (2004). However a more nuanced picture is painted by Von Hagen (2006) and Buti and Giudice (2002). These authors present evidence that the Maastricht treaty and the related convergence period reduced deficit levels, but that this disciplinary effect disappeared with the introduction of the euro. This difference can be explained by the fact that the rewarding aspect of these rules (accession to the eurozone) during the convergence period has spurred fiscal consolidation, whereas the Pact lost much of its disciplining power once Member States adopted the euro, thereby irrevocably eating the carrot that once guided public finances. Conversely a number of studies find no significant effect of (post) EMU fiscal rules (Freitag and Sciarini 2001; Gali and Perotti 2003; LeMay-Boucher and Rommerskirchen 2014). Although the effectiveness of the SGP is almost exclusively studied in the context of EMU it is worth stressing that it applies to all EU Member States, albeit without the possibility of sanctions for those outside the eurozone. During the Great Recession the EERP created a new, albeit loosely defined, agreement on fiscal policy coordination for all 27 Member States.

The literature on domestic fiscal rules, such as the Golden Rule<sup>53</sup> or debt ceilings, largely suggests that they reduce budget deficits.<sup>54</sup> Several studies find that the presence and/or strength of fiscal rules in the USA are associated with faster policy initiatives to reduce deficits (e.g. Alt and Lowry 1994) or lower budget deficits overall (e.g. Alesina and Bayoumi 1996). Similar evidence for Canadian provinces shows that provincial deficit rules lead to stronger budget balances (Tellier and Imbeau 2004). The evidence for EU Member States predominantly points to the beneficial effect of national fiscal rules on the soundness of public finances.

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<sup>53</sup> The golden rule stipulates that over the economic cycle, the government should borrow only to invest, – not to fund current expenditure.

<sup>54</sup> A related body of literature focuses not only budgetary rules but takes the whole budgetary procedure into account. Various studies have confirmed the effectiveness of specific budgetary procedures in improving fiscal performance (e.g. Poterba and von Hagen 1999; Hallerberg *et al.* 2009).

Examining the overall size of public spending in the EU between 1990 and 2005, Debrun *et al.* (2008) show that countries with strong expenditure rules have lower primary expenditure-to-GDP ratios.<sup>55</sup>

Turrini (2008) shows that the pro-cyclical spending bias was less pronounced in EU countries with strong expenditure rules. Yet in times of crisis, the question becomes how expenditure rules impact *anti-cyclical* spending. If strong fiscal rules reduce the deficit bias of policy makers, is it sensible to assume that the same rules exert this moderating influence even in times of crisis, when a) most rules do not apply due to built-in exceptionality clauses<sup>56</sup> and b) the overarching European crisis framework under the EERP explicitly calls for expansionary fiscal policies? Arguably the answer is yes. On the one hand, it can be assumed that countries with strong fiscal rules were in a better budgetary position to flout their fiscal thresholds<sup>57</sup> to begin with and therefore had more room for manoeuvre to follow the EU-wide call for fiscal expansion.<sup>58</sup> This would therefore make them less likely to engage in stimulus free riding. On the other hand, Member States with stronger fiscal rules might have been more attuned to the necessity for fiscal consolidation once the recession stopped and therefore implemented more moderate stimulus programmes, which are more easily reversed. To summarise, strong fiscal rules are expected to curb fiscal free-riding, although given the weak record of EU-level fiscal institutions, the impact of domestic rules is likely to be more important.

### ***Market discipline***

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<sup>55</sup> For more evidence on EU/OECD countries see Turrini 2008; Wierdsma 2008; Basinger 2009; Holm-Hadulla 2012.

<sup>56</sup> However Schuknecht (2004) argues that it is not important whether fiscal rules bind in a strict sense because they serve as benchmarks against which imperfectly informed electorates evaluate governments' fiscal performance. Put differently, they represent the 'fiscal norm', which policy-makers should aim for.

<sup>57</sup> Especially given that rules regularly have built in escape clauses (i.e. the rule does not or only partially apply in times of exigency)

<sup>58</sup> This logic is summarised in the Commission's endorsement of domestic fiscal rules: 'Enforced national expenditure rules [...] help to counteract forces leading to pro-cyclical fiscal policy in good times and thus prevent the need to retrench in bad times' (European Commission 2004: 37).



The literature on market discipline examines if and how financial market participants constrain sovereign borrowers.<sup>59</sup> This alleged ability is described by the market discipline hypothesis (MDH, see Bishop 1992, Lane 1993). Ever since the post-Bretton Woods era, market discipline has been seen as a force for fiscal prudence, with proponents ‘[applauding] the way international financial markets would discipline government policy and force states to adopt more conservative, “sound” fiscal [...] programmes’ (Helleiner 1996: 324). Market discipline is said to be able to ‘deter a borrower from maintaining an unsustainable path of borrowing’ (Lane 1993: 83). To this end, the MDH hinges on the responsiveness of both financial markets and national policy-makers. On the one hand, financial markets must react to fiscal policy changes. On the other hand however, borrowers must respond to market signals.

Market discipline was, and still is, considered to be a key ingredient for the functioning of EMU due to an apparent asymmetry. Eurozone Member States, albeit able to issue debt in their own right, are limited in their policy options in the face of financial difficulties because they are no longer in charge of monetary policy. This gave rise to one of the ‘founding fears’ of EMU, namely that governments would seek either monetary bail-out from the European Central Bank (ECB) or a fiscal bail-out from other member-states. It was thought that ‘to the extent that market-imposed discipline leads to more prudent fiscal policies and helps prevent fiscal crises in federal states and monetary unions, it protects the citizens against having to pay for the profligacies of the governments of other states’ (Schuknecht *et al.* 2009: 371).

To analyse the responsiveness of financial markets, fiscal policy outcomes are modelled as determinants of government’s borrowing costs, measured as bond

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<sup>59</sup> For a comprehensive review on the financial market side of the capital market-national government nexus see Mosley (2003: ch 2).

spreads, credit default swap (CDS) spreads,<sup>60</sup> interest expenditure (debt servicing costs) or changes in interest rates. The majority of empirical studies point to a significant effect of market punishment for ‘excessive’ fiscal policy (e.g. Dewachter and Toffano 2012). Lonning (2000) finds a positive and mostly significant impact of government debt and deficits on government bond yields, comparing the yields of a small sample of bonds issued in Deutsche Mark of 11 EU governments with equivalent German government bonds. The findings of Bernoth *et al.* (2004) confirm this relationship although argue for a stronger effect. Addressing the question of how bond yield spreads react to fiscal consolidations, Ardagna (2009) finds that interest rates of 10-year government bonds decrease, on average, by 124 basis points around episodes of fiscal consolidation.

Whilst empirical studies of the first side of the MDH (market’s responsiveness) are abundant <sup>61</sup>, the second side of the MDH (borrowers’ responsiveness) has been comparatively neglected in the literature. For the purposes of this study I am interested in the second side of market discipline. Does market punishment offer a strong incentive for ‘sound’ fiscal policies? Do sovereign borrowers react to interest rate penalties demanded by financial markets? The existing literature suggests that credit market punishment restrains sovereign borrowers. Analysing the determinants of changes in the primary debt levels of 10 OECD countries for the 1980-1996 period, de Haan and Sturm (2000) find that financial markets (measured by the debt servicing costs as a percentage of total debt) have a disciplining effect on government’s fiscal position. Heinemann and Winschel (2001) analyse the fiscal performance of 19 OECD countries between 1970 and 1998 and show that borrowing costs, measured as the interest-growth-differential<sup>62</sup>, have a significant impact on the primary surplus. However this impact is asymmetric: reactions in times of increasing borrowing costs are more pronounced than in times of decreasing

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<sup>60</sup> The CDS is a credit derivative which allows the buyer to purchase insurance against the risk of default.

<sup>61</sup> *Inter Alia* Afonso and Strauch 2004; Codogno *et al.* 2003; Faini 2005; Malritz 2012.

<sup>62</sup> The differential between the interest rate paid to service government debt and the GDP growth rate is a key measurement to assess fiscal sustainability.

interest rates. Molnar (2012) analyses the effect of high interest rates on budget consolidations, finding that high interest rate differentials have a positive impact on the start of very large consolidations. Nickel *et al.* (2010) assess which factors determine the probability of major debt reduction (defined as a decline of the debt-to-GDP ratio of at least 10 percentage points in 5 consecutive years) in the EU-15 during the 1985-2009 period. The authors show that high debt servicing costs played a ‘disciplinary role’ and forced governments to reduce public debt. Bulut’s (2012) comprehensive analysis of 40 developing countries stands out because the author explicitly considers both aspects of market discipline; in various model specifications he finds little evidence for borrowers’ responsiveness, whereas the primary structural budget balances is shown to impact negatively on a country’s risk premium. Wagschal and Wenzelburger (2012) model market discipline as part of a so-called ‘misery index’ which measures the economic pressure for reforms.<sup>63</sup> It is this pressure that then provides the Olsonian incentive. Interest rates still qualify as ‘separate and selective’ despite well-documented contagion effects; at the origin they are country-specific. Financial market discipline is likely to provide a particularly strong incentive due to the fact that it takes the form of both punishment (high interest rates) and reward (low interest rates). It offers both carrot and stick. Based on these studies, I expect to find a positive relationship between deteriorating sovereign borrowing conditions and fiscal indicators.

### **Free-riding hypothesis**

If group latency and weak incentives are identified, free riding becomes a concern. According to the free-rider problem, individuals only partially bear the adverse consequences of reducing their effort concerning fiscal stimulus or consolidation policies. Consequently, collective effort typically falls below the optimal level. Fiscal free-riding can take the forms of both stimulus and growth free-riding. The empirical

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<sup>63</sup> Although oddly and to Wagschal and Wenzelburger’s puzzlement (2012: 68), when regressed separately, their findings indicate that a high short-term interest rate *reduces* the probability of consolidation.

study of fiscal policy coordination in times of crisis is challenging; in the absence of clear numerical rules for fiscal stimulus policies, measuring the success of fiscal policy coordination is problematic. This challenge is echoed in the scepticism of an interviewee from a Member States' Permanent Representation in Brussels, who when told about the subject of this thesis quipped, 'so how are you going to write about something that does not exist?' (author interview, May 2011). There is little reason to organize a project on the chimerical promise of measuring the immeasurable. First, as a crude proxy for group oriented behaviour I will consider national stimulus programmes vis-à-vis the self-imposed EERP value of 1.2 per cent of GDP. Secondly, I will consider fiscal packages in relation to a country's fiscal space. To do so, I will construct a measure of fiscal space based on the indicators used in the newly created Macroeconomic Imbalances Procedure (MIP) to obtain a suitable yardstick for crisis responses. Fiscal policy coordination is again that Member States shoulder fiscal expansion in accordance of their fiscal room for manoeuvre. Fiscal response strategies that fall short or (largely) exceed a country's fiscal space are an indicator of growth or stability free-riding respectively. The analysis seeks to distinguish between group-desirable and group-undesirable free-riding. Finally, I identify two main factors that are likely to contribute positively to the incentive and opportunities for free-riding (see below). This allows me to test empirically for the lure of free-riding.

A word of caution is, however, in order. By starting from a negative assumption about the malfunctioning of collective action, results might be prejudiced towards unearthing just that. Two factors mitigate this bias. First, the majority of fiscal outcome variables as well as all 'free riding variables' are 'value-free' variables in the sense that they reflect real world policies/characteristics. It is therefore unlikely that the empirical analyses suffer from a negative bias. Secondly, the interview material complementing the empirical findings has been gathered with this problem in mind. Therefore, when wording the questions, interviewees were not initially

asked about ‘free-riding’ problems, but the subject was first introduced by asking how Member States contributed to fiscal policy coordination. Only then as a follow up to a negative assessment of fiscal policy coordination were interviewees asked about free-riding behaviour. Introducing, a ‘positive bias’, so to speak, seemed further appropriate as these interviews were conducted in the spring of 2010 when the Sovereign Debt Crisis was in full swing and the general perception of fiscal policy coordination was one of glaring failure. The main hypotheses guiding chapter seven are:

*H3a: Fiscal policy coordination was marred by free-riding between 2008-2010.*

*H3b: Fiscal policy coordination was free from free-riding between 2008-2010.*

### **Determinants of free-riding**

In order to ascertain and explain the phenomenon of fiscal free-riding during the Great Recession, two main ‘free-riding variables’ are explored. These relate to the size of a Member State and its trade openness, aspects that are able to elucidate both a country’s political ability and its structural capacity to free-ride. Both relate to the notion of asymmetric interdependence discussed in the previous chapter.

#### ***Size***

Various authors comparing the compliance rates with the SGP of small and large Member States have suggested that size matters when it comes to respecting E(M)U’s fiscal rules. Von Hagen *et al.* (2000) argue that the superior track record of small Member States may be due to their being accustomed to external influence over domestic policy and therefore their readiness to accept a supranational framework for the conduct of fiscal policy. This ‘accustomisation’ is, according to de Haan *et al.* (2004), ascribed to the fact that small Member States tend to have less bargaining power. This makes them feel the loss of reputation from violating the SGP more

acutely (*ibid.* see also Meyer 2004, as well as Schure and Verdun 2008 on the different preferences about the SGP's application for large and small Member States).<sup>64</sup>

A similar distinction between small and large countries applies to fiscal consolidation. Buti and Pench (2004) show that the price of fiscal consolidation tends to be higher in large countries because fiscal multipliers are greater.<sup>65</sup> What is more, fiscal consolidation is helped by strong growth. This is achieved by reducing the budget deficit directly via the reduced effect of automatic stabilisers, the increasing denominator (GDP), but also by easing 'structural consolidation to the extent that carrying out restrictive fiscal policies may be easier when the overall cake is growing and it is therefore easier to compensate the losers' (*ibid.* 1028). Fatas and Mihov (2003) argue that since the start of EMU large countries have grown considerably more slowly than smaller countries, which hampered their retrenchment efforts. Looking at compliance with the SGP, von Hagen (2007: 33) notes that it is the small states that respect the Pact, which 'matters the least, since a fiscal crisis in a small EMU Member State would hardly threaten the stability of the common currency'. With the benefit of the hindsight this statement surely requires further qualification.

An alternative argument to the big-versus-small Member States divide highlights the impact of state power at the decision-making stage. The political weight of a Member State is closely related to its assertiveness, that is, its ability to shape agreements according to its preferences (Thomson *et al.* 2007). If large Member States are able to influence the outcome of negotiations, this will positively impact their ability and willingness to comply with a given agreement. Large Member

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<sup>64</sup> The fiscal governance argument (e.g. Hallerberg and von Hagen 1999), not tested in this study, explains the disparities by pointing to the quality of domestic budgetary institutions, which differ between large countries (which are usually *delegation* states) and smaller Member States (which are predominantly *commitment* states).

<sup>65</sup> Put simply, the higher the multiplier, the more painful deficit reduction.

States, notably France and Germany, were very active in the design of the EERP. One might argue that non-compliance on their part is therefore unlikely given the high degree of preference attainment.<sup>66</sup> But given the rapidly altered economic and political realities of policy-makers I doubt whether this is a sufficient condition. The preferences held at the negotiation stage in late 2008 are not necessarily the same as throughout the Great Recession, when the fiscal response strategy was re-adjusted. In sum, I expect large Member States to be more likely to implement fiscal free-riding policies.

### *Openness*

Openness is the second factor said to influence a country's propensity to free-ride. There is a well-established link in the literature, as small countries tend to be more open.<sup>67</sup> In fact large parts of the discussion on the fiscal policy choices of open economies discuss small *and* open countries. Ever since Cameron's influential study (1978), numerous scholars have found a positive correlation between a country's openness (trade exposure) and government expenditure. Cameron (*ibid.*) puts forward a 'compensation hypothesis' and explains this by suggesting that small economies are more likely to shelter their economies from the competitive risks of the international economy. Building on this work, Ruggie's embedded liberalism argument (1982) depicts a political compromise in which policy makers open their countries to freer trade while managing the dislocations that follow via increased expenditure.<sup>68</sup>

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<sup>66</sup> Looking back in history the alleged degree of preference attainment did not prevent both countries to breach the SGP's three per cent threshold. However, crucially this thesis considers a comparatively short timeframe, where agreeing and enacting coalitions are largely identical in Germany and France.

<sup>67</sup> Small countries with small domestic markets have limited opportunities to exploit economies of scale, which leads them to expand their market size through international trade (Alesina and Wacziarg 1998).

<sup>68</sup> See also Rodrik (1998) and Kurtz and Brooks (2008).

A second strand of the literature examining the fiscal policy choices of open economies however questions the effectiveness of public spending. The Meade (1951) model suggests that at times of collapsing aggregate demand, economies that are more closed (or less open) should opt for larger fiscal stimuli. Trade openness implies lower fiscal multipliers, as a share of the stimuli would ‘leak’. Cameron (2012) argues that during the Great Recession concerns over such ‘leakages’ were strong amongst EU Member States. In light of this literature, open/small economies are expected to be less likely to engage in stimulus free-riding.

## **Research Methods**

In the tradition of International Political Economy (IPE) and specifically European Political Economy (EPE), this thesis will comprise of empirical social science research. This thesis rejects the notion that all research methods inextricably carry epistemological obligations (the embedded methods argument). Furthermore, it begs to differ that quantitative and qualitative research are separate paradigms, which are incompatible and incommensurable (the paradigm argument). It is worth noting that the sharp distinction between qualitative and quantitative methodologies has been questioned in the literature by numerous accounts and it seems that the existing divide is one of methodological training and knowledge rather than one of epistemological paradigms. A mixed-methods strategy offers several methodological advantages. First, the goal of pursuing different research strategies is to expand the understanding gained from one method by incorporating the insights of another. This strategy is then able to confirm, cross-validate, or corroborate findings within a single study, in order to obtain a more comprehensive account of the object of enquiry. As Yin (2003) notes, the development of converging lines of evidence is a sound method of enhancing research validity. Triangulation of methods and measures has established itself as a clear hallmark of applied research. Ultimately the mixed-methods approach is meant to counterbalance the weaknesses and shortcomings inherent within one method with the strength and advantages of another.



Furthermore, with respect to the large body of EPE literature on European integration and more specifically fiscal policy coordination, the methodological plurality of this study aims at bridging the divide between American and European scholarship (Verdun 2005). The end product thus aspires to plant a study that goes beyond the dominating ‘monocultural accounts’ (McNamara 2009) and appeals to a broad audience on both sides of the Atlantic.

## **Case Study Research**

According to Odell (2001: 56) ‘case study methods have dominated the study of IPE over the last three decades’. This thesis uses case study methods to cast light on the dynamics of fiscal policy and its coordination in the EU. Often the selection of suitable cases presents itself as the primordial task of the case study researcher searching for ‘explanatory’ or ‘pathway’ cases (Yin 2003; Gerring 2007). Yet the genesis of this research project began not with the undertaking to pair a theory – to be proven or refuted – with appropriate cases. Instead the spark of origin can be traced back to the beginnings of the economic and financial crisis in late 2008, which precipitated an interest in the question of what would happen to fiscal policy and its coordination in the EU. The task at hand was thus not to find single or multiple cases, but instead to construct a robust research design that would facilitate fruitful and coherent analysis. At first glance this thesis can be classified as a single-outcome study, defined by Gerring (2007: 710) as investigating ‘a bounded unit in an attempt to elucidate a single outcome occurring within that unit’. Yet, on a second level this thesis is both idiographic, insofar as it purports to shed light on a set of 27 Member States within the EU, as well as nomothetic insofar as it reflects on broader questions of European integration.

The case study design of this thesis matches Odell’s (2001) ‘disciplined-interpretive case study’. In this approach the analyst applies an existing body of theories to scrutinise a particular new event. A case is understood to constitute ‘a single instance

of an event or phenomenon' (*ibid.*162). In this case study, the EU Member States (N=27) compose the group that forms the case unit. Within this study multiple observations of theoretically relevant variables will be tested. The central and sole criterion for selecting these countries was their membership in the EU.<sup>69</sup> This thesis focuses not only on those countries that are Member States of the eurozone, despite the greater need for fiscal policy coordination resulting from the single currency. Such a focus is justified by the fact that the larger rationale for fiscal policy coordination applies to all EU Member States, as has been argued in the previous chapter. This is made explicit in the EERP, which calls on all EU countries to stimulate their economies. Including all Member States in the study can increase robustness of results, or in social science terminology ensure higher typicality and maximise inferential leverage. To create a comprehensive understanding of the scope and limits of fiscal policy coordination in the EU, it is essential to include all of its Member States. Not doing so would increase the propensity to omit evidence. This 'umbrella approach' fits closely aggregated analyses in EPE studies (e.g. Dyson and Featherstone 1999; Ardy *et al.* 2006). It brings a decreasing level of detail in each Member State, which will be justified by the explanatory leverage gained into the research question of interest.

Having argued for the inclusion of all 27 EU Member States, the case for the exclusion of non-EU states must also be made. After all, fiscal policy coordination was not confined to the EU. While national governments worked on their response to the economic crisis, three supranational organisations, the G20, the IMF, and the Organisation for Economic Co-operation and Development (OECD) attempted to coordinate these national fiscal policies (Armingeon 2012). Particularly the attempts, and self-proclaimed success, of macroeconomic coordination within the G20 come to

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<sup>69</sup> As of 2012 these are (year of entry): Austria (1995), Belgium (1952), Bulgaria (2007), Cyprus (2004), Czech Republic (2004), Denmark (1973), Estonia (2004), Finland (1995), France (1952), Germany (1952), Greece (1981), Hungary (2004), Ireland (1973), Italy (1952), Latvia (2004), Lithuania (2004), Luxembourg (1952), Malta (2004), Netherlands (1952), Poland (2004), Portugal (1986), Romania (2007), Slovakia (2004), Slovenia (2004), Spain (1986), Sweden (1995), United Kingdom (1973).

mind (Rommerskirchen 2013a). The G20, a comparatively young multilateral forum, is an interesting, yet compared to the EU experience, less rich case. Fiscal policy amongst G20 Member States is a very underdeveloped area of coordination compared to that in the EU. First, this distinction must be seen against the backdrop that fiscal independence among EU Member States is much higher than among the dispersed G20. Collective action problems are therefore less pronounced with respect to stability or growth free-riding. Consequently, incentives to motivate group-oriented behaviour are scarce. The existing architecture in the EU dwarfs international agreements on public finances. Even the EERP, however evasive it may be, is still the most substantial inter-governmental agreement on the coordination of fiscal policy responses during the Great Recession. This is not to suggest that fiscal policy coordination among states outside the EU is not worth studying; Empathically it is, yet the unique experience of the EU is not readily transposed to other countries as well, which is why it would stretch this study to include other countries, however strong their economic links with the EU.

## **Qualitative Analysis**

In order to investigate fiscal policy and its coordination in times of economic crisis, this research project relies on two qualitative methods: documentary analysis and elite interviewing. Employing sources for qualitative data calls for processing, analysing and interpreting the data to transform it into a meaningful source of inference (McNabb 2004: 434).

## **Documentary Analysis**

Documentary analysis can make a vital contribution to the understanding of contemporary events: the use of documents can corroborate information and augment evidence from other sources (Yin 2003: 81). For this research project, primary, secondary and tertiary documents were used. Each was assessed on the basis of its quality according to criteria such as authenticity, credibility and representativeness (Scott 1990: 30-31). What is more, the analysis of the documents took questions of origin, purpose and original audience into account. Ideally, most of the data analysed in this project originates from primary sources. Primary sources consist of evidence that was produced at the time of the event. For the purpose of this research project, documents and statements produced by EU institutions such as the Council, the Commission and the ECB, as well as Member State governments related to fiscal policy and its coordination in times of economic crisis were collected. Documents produced by the OECD, the IMF, and the International Labour Organisation (ILO) were also examined.

### **Elite Interviewing**

This thesis relies further on 42 confidential interviews with key bureaucrats and policy-makers working on EMU. Interviews were conducted at the European Commission, the European Council, the European Parliament (EP), Permanent Representations of the Member States to the EU and the IMF. The decision to interview broadly across different institutions is based on the ‘fragmentation of responsibilities’ (Hodson and Maher 2001: 645) of fiscal policy coordination. All institutions of the EU contribute to fiscal policy coordination in the eurozone to various degrees. Although not all are equally powerful, it is nevertheless not possible to single out one institution as the main locus for fiscal policy coordination. The European Council is responsible for setting the main policy orientations and manages a plethora of committees and policy coordination processes under its ambit. Here I interviewed members of the DG Economic and Regional Affairs. The EU’s Committee of Permanent Representatives, or COREPER, is responsible for preparing

upcoming ministerial meetings of the Council and has long been a major player in the EU system (see Lewis 2005). Interviews here offer a bridge to national perspectives on fiscal policy coordination. Interviews were conducted with staff of representations' economic and financial affairs division or their functional equivalent, and in one case with the Permanent Representative to the EU.

Within the Commission, the Directorate General of Economic and Financial Affairs (Ecfm) is responsible for fiscal policy coordination. It monitors performance and compliance, acting as the representative of the EU interest and as such is present at most Council and Committee meetings. The Commission's power in fiscal matters is perhaps greatest with respect to the SGP, notably due to its reports that form the basis of the Ecofin's assessment of national stability programmes and the fact that the EDP is triggered by a recommendation from the Commission. Eurostat has the role of regulator of Member States' fiscal accounting, watching over the accounting of budget deficits or public debt. Interview material from the Commission's statistical agency was especially helpful for chapter four which identifies appropriate measurements of fiscal policy choices. During the Great Recession the Commission President Barroso played an active role in the orchestration of stimulus policies, as chapter six describes. One member of his *cabinet* was therefore interviewed as well. What is more, I interviewed members of the DG Competition's newly created Task Force Financial Crisis, as well as its general State Aid division. This decision was motivated by the fact that fiscal policy choices during the Great Recession were potentially at odds with EU state aid rules. What is more, said Task Force is active in the country programmes of EU Member States receiving financial assistance and its members are very well informed about various reform proposals relevant to this study.

The EP is excluded from most coordination procedures and has no say in the implementation of the SGP and fiscal policy coordination more broadly. Members do however have access to information via shared documents and hearings. Specifically,

I interviewed members of the Committee on Economic and Monetary Affairs, who work on matters of fiscal policy coordination. Finally, I also conducted interviews at the IMF. During the Sovereign Debt Crisis the IMF has gained importance for fiscal policy coordination in the EU, notably through its role in the Troika, surveilling, and some would say directing, fiscal and macroeconomic policies in Greece. This development caused Hodson (2013a: 1) to proclaim that ‘the IMF emerged as a *de facto* decision-making body of the EU’. But even before 2010, the IMF was an active commentator on national and EU-level fiscal policy. These interviews incorporate an outsider’s perspective.

### **The interview experience**

I contacted 105 individuals for the initial interviews, completed 42 interviews, received 26 refusals and 37 non-replies, leaving a 40 per cent response rate. The general reasons given for refusal were scheduling problems and a lack of time. Interviews took place almost exclusively at the interviewee’s place of work. Most of the information gathered during the interviews was explicitly ‘not for attribution’ (e.g. Goldstein 2002), that is to say the information could be used and quoted provided that the individual would be granted anonymity. Five interviews were conducted over a series of email exchanges, the remainder face to face. Interview length varies considerably, ranging from 30 to 150 minutes. To encourage interviewees to speak freely, the discussion was not recorded. Instead I took partial notes during the interview while maintaining eye contact to further the conversational tone and completed the notes immediately following the interview with memory still being fresh. In deciding how many interviews to conduct, this research was guided primarily by ‘thematic saturation’, continuing to interview so long as the evaluation of fiscal policy coordination during the Great Recession continued to be markedly modified or added to substantially by the interviews. The interviews were relatively unstructured in form to capture more qualitative aspects of the challenges and dynamics of fiscal policy coordination. As such, the semi-

structured interviews were based around a range of questions depending on the interviewee's job description, responsibilities and (in some cases) previous expertise, covering subjects as appropriate. These open-ended questions allowed respondents to organise their answers within their own framework (Aberbach and Rockman 2002).<sup>70</sup> Using semi-structured in contrast to fully structured interviews is considered to further complement the quantitative evidence of this thesis and to offer a deliberate counter-weight to the, particularly in the context of binary variables, unsubtle generalisation inherent to quantitative analysis. Semi-structured interviews further allow the researcher to attain 'a delicate balance between covering the topics that are considered significant by the interviewer and allowing the respondent to open new routes on topics without taking unrelated tangents' (Goldstein 2002).

### **Using interview material**

This analysis usually draws on individual interviews when exemplifying general tendencies or corroborating previous findings from other sources. In addition to exercising critical judgement of the information provided by interviewees (of which aspects might be coloured by judgements and prejudices), I confronted them with different positions or apparent incongruities. What is more, interview material has not only been checked for consistencies and conflicting evidence, but also cross-referred to written documents where possible. For the purpose of minimising potential methodological problems of elite interviewing, interviewees have been selected to control for known political, national, and institutional divides in EU politics and an effort was made in the selection of interviewees to cover each country and to ensure a fair distribution in terms of age, background, and nationality. Despite my best efforts to ensure a representation of different nationalities, Germans are over-represented in my interviews (10 out of 42). This bias stems largely from the strong presence of Germans in the European Commissions, particularly in DG

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<sup>70</sup> 'Elites especially – but other highly educated people as well – do not like being put in the straightjacket of close-ended questions' (Aberbach and Rockman 2002: 674).

Ecfín.<sup>71</sup> It is also possible that my own nationality, and more specifically a mention of my research's sponsor, the German National Merit Foundation, of which at least two of my interviewees were alumni, led to a higher response rate from fellow citizens. In the light of Germany's prominent role in matters of fiscal policy coordination, this bias is however not unwelcome, provided interview material is critically compared and cross-referenced.

## **Quantitative Analysis**

The advances in the statistical methodologies used for evaluating hypotheses on the interrelations between economic development and political reactions over the past two decades have been impressive. While political science research has yet to catch up with this cornucopia of econometric innovation, the various pitfalls arising in the application of quantitative methods in comparative political economy are by no means restricted to disciplinary boundaries (e.g. Kittel and Winner 2005). Regression analysis will be employed to form a basis for some of the hypotheses, notably to assess determinants of fiscal policy-making during the crisis. The empirical material will be appreciated in relation to the qualitative material. Awareness that regression analysis produces a different way of knowing different realities is crucial. A regression analysis does not focus upon countries; rather they constitute an aggregation of numbers of observations. Uncontrolled state-specific characteristics of the variability are lost. It is therefore all the more important to balance this apparent weakness with informed qualitative analysis on the eurozone Member States. The case study elements are hence crucial to check whether their evidence supports the claims made by quantitative analysis. By checking for rival interpretations (those that were for instance not attributed with statistical significance in the model) as well as omitted considerations (factors that are not readily quantifiable), the case study approach compensates for the limitations of quantitative

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<sup>71</sup> According to the European Commission's statistical bulletin (2013) more than 10 per cent of employees of the DG Ecfín held German nationality (67 out of 626).



analysis. In addition to traditional regression analysis, chapter seven also engages in Qualitative Comparative Analysis, which aims to combine some of the strengths of qualitative and quantitative research methods.

## **Conclusion**

This chapter has developed the three main hypotheses of this study. They are again:

*H1a: Fiscal policy coordination in the EU takes place in a latent group between 2008-2010.*

*H1b: Fiscal policy coordination in the EU does not take place in a latent group between 2008-2010.*

*H2a: Free-riding was kept at bay due to select and separate incentives between 2008-2010.*

*H2b: Free-riding was not reined in by select and separate incentives between 2008-2010.*

*H3a: Fiscal policy coordination was marred by free-riding between 2008-2010.*

*H3b: Fiscal policy coordination was free from free-riding between 2008-2010.*

Before testing these hypotheses the following chapter will turn to the question of how to measure fiscal policy and its coordination.

## **CHAPTER 4: MEASURING FISCAL POLICY OUTCOMES**

### **Introduction**

The context of the Great Recession poses several challenges to the analysis of fiscal policy coordination. Some of these are relevant irrespective of the quality of economic climate: How to measure discretionary spending? How reliable are indices of automatic stabilisers? How should one (if at all) distinguish between voluntary and involuntary compliance with EU's fiscal rules? Some concerns however, have emerged as a direct result of the economic and financial crises. First, the Great Recession saw unprecedented government intervention in the financial sector with substantial consequences for deficit and debt levels. How should these rescue operations be reflected in the measurement of the fiscal policy variables? Secondly, for the first time EU rules explicitly call for excessive deficit spending. Prior to 2008 the common characterisation of free-riding behaviour was that of countries breaching the SGP. With the Great Recession the predominant concern temporarily turned to stimulus free-riding. How should we define a compliance variable with the comparatively vague mandate for stimulus spending? Given that these considerations, due to the timeliness of this thesis, have been addressed by comparatively few studies, this chapter will discuss appropriate measurements for fiscal policy outcomes in times of crises that are used as dependent variables in the subsequent chapters.

This chapter proceeds as follows. First, I present the measurements of fiscal policy choices used in this study, before discussing concerns of automaticity and intentionality. Subsequently, the impact of the interventions to support financial institutions and financial markets on public finances is discussed. In the fourth section, I lay out the strategy for measuring fiscal policy coordination.

## **Fiscal policy and its components**

Fiscal policy is inherently concerned with resource allocation and distribution and is thus at the core of state activity. Fiscal policy creates conflicts of interest both with respect to its macroeconomic function (i.e. to ensure fiscal sustainability and a degree of stabilisation of the economy) as well as its microeconomic function (i.e. to ensure efficient and effective allocation of public resources). The government provides budgetary support to the economy, which can be broadly captured by the year-on-year change in the general government budget balance as a share of GDP. Given that countries have country-specific levels of deficit and debt levels, it makes sense to take the previous level into account – hence the interest in changes.

Government revenues and expenditure make up the overall fiscal balance. Looking at the overall budget balance (BB), one can distinguish between the primary balance (PB), the structural balance (SB) and the primary structural balance (PSB). For the primary balance, given that this measurement is generally considered outside the control of the government, expenditure on interest is filtered out. While interest payments are to a large extent dependent on a country's economic outlook and debt sustainability, they can be subject to fluctuations outside the control of national policy-makers. According to Fedelinio *et al.* (2009: 1), 'interest payments are often kept separate because their movements, while "automatic" in the sense of not generally reflecting discretionary fiscal policy actions, may not be necessarily correlated with cyclical output changes'. The PSB excludes not only interest expenditures but also spending linked to the operation of automatic stabilisers.

Automatic stabilisers are features of the tax and spending system that react automatically to the economic cycle in order to reduce the severity of its fluctuations. The structural deficit requires two inputs: first, the cyclical position of the economy as measured by the output gap (the distance between actual and potential output) and second, the responsiveness of the budget balance to the economic cycle, as expressed by budget semi-elasticities. The semi-elasticities measure the reaction of the balance-to-GDP ratio to cyclical conditions and are derived from national tax codes as well as

from regression analysis.<sup>72</sup> This measurement is generally used for the purpose of budgetary surveillance by both national governments and international institutions, including the European Commission, the OECD, the IMF and the ECB. Changes in the PSB are considered to be indicative of discretionary policy decisions and not merely a product of output fluctuations. Put differently, the structural balance excludes that part of the change in the budget balance that follows automatically from the cyclical conditions of the economy due to the reaction of public revenue and expenditure to changes in the output gap. The basic idea in using changes in the PSB is that, once the budget is purged of its cyclical component plus interest expenditure, any remaining difference across time should indicate deliberate policy interventions.

### **Discretionary fiscal policy: the state of the literature**

There is no consensus in the literature on the appropriate methodology for the construction of a cyclically adjusted measure of fiscal policy (see Alesina and Perotti, 1995; Giavazzi and Pagano, 1996, Alesina *et al.* 2002). Following the Commission's definition (European Commission 2009), a country's discretionary crisis policies are defined as the change in the PSB relative to the preceding period. When the change is positive (negative) the fiscal stance is said to be expansionary (restrictive). The usage of cyclically-adjusted budget balances as an indicator for discretionary fiscal policies has been favoured by numerous studies (e.g. Ballabriga and Martinez-Mongay 2002; Wyplosz 2006; Turrini 2008; Afonso 2009; Fatas and Mihov 2009). Galí and Perotti (2003) for example estimate that fiscal policy in a panel of eurozone countries has become pro-cyclical for the period that followed the entry into force of the Maastricht Treaty (1992-2002). Analysing the breakdown between cyclically-adjusted spending and revenue, they show that both of these components seem to

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<sup>72</sup> See Larch and Salto (2005) for a detailed description.

have become a-cyclical over the period considered.<sup>73</sup> Beetsma and Giuliodori (2010) consider the cyclically-adjusted primary deficit in their analysis on the disciplining effect of the SGP. In light of the consolidation efforts in the run-up to EMU, the authors suspect that there may be persistence in the PSB, which would result in a positive bias of the PSB and therefore an overestimation of the ‘SGP effect’. To control for this potential bias they construct an ‘exogenous PSB’, which is estimated as the residuals of regressions of the PSB on its first two lags.

The Commission’s method is not however the only approach to decomposing fiscal policy into discretionary and cyclical components. Fatas and Mihov (2003), for instance, partial out business cycle effects by regressing the fiscal policy measure on variables related to the state of the economy.<sup>74</sup> The obtained residuals are considered to represent discretionary fiscal policy, as they account for the part of the fiscal policy measure unexplained by economic fluctuations. Here the authors follow Gali and Perotti’s distinction (2003) not only between the structural and cyclical component of fiscal policy, but also between an endogenous and exogenous structural component. In so doing, Fatas and Mihov (2003) are interested in explaining discretionary policy.

Larch and Salto (2005) criticise the PSB approach for ignoring the effects of over- or underestimating growth in the planning phase of the budget, coupled with inertia in the implementation phase.<sup>75</sup> The PSB deteriorates (improves) when potential growth

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<sup>73</sup> Larch and Salto (2005) contest this finding, arguing that it can be explained by the increase in prediction errors post 1999, i.e. the reluctance of fiscal policy makers to accept a lower growth potential. In my view there is no reason to assume that this reluctance would be any greater after 1999, especially in the context of qualifying for eurozone membership during the previous period which could just as well lead to a greater incentive to exaggerate growth projections (this would be in line with the aforementioned literature on account gimmickry which touches on deficit and debt accounting and not on the calculation of GDP growth). Strauch *et al.* (2004) provide evidence for a systematic tendency in some Member States to overestimate potential growth (see also Cottarelli 2012).

<sup>74</sup> Lane (2003) and Sorensen *et al.* (2001) also adopted the regression-based measures to study the cyclical behaviours of fiscal policy.

<sup>75</sup> See *inter alia* Canova (1998) and Jaeger and Schuknecht (2004) for a critique related to the estimation of the output gap and Darby and Melitz (2008) as well as in’t Veld *et al* (2012) for a critique on the computation of spending elasticities.

is over-(under-)estimated. In the context of the 2008 to 2010 period it is well documented that growth assumptions were too positive (European Commission 2008), which means that the size of discretionary fiscal policy would be overestimated. Put differently, a change in the PSB does not necessarily point to active fiscal stimulus policies such as tax cuts or expenditure increases. Instead the change can simply stem from passive behaviour in the event of lower than projected underlying growth. The authors argue that this problem is aggravated by the inertia of fiscal policy in the implementation phase, which makes it ‘safe to assume that contemporaneous corrections for growth “surprises” will be limited’ (Larch and Salto 2005: 9). Does this assumption still apply in times of crisis? The fact that the majority of countries reacted swiftly with emergency budgets and revised stimulus plans, fine-tuning their budgets as late as 2010, suggests that the answer is no. Consequently, possible ‘inertia bias’ inherent in the PSB should be less acute during the Great Recession. I accept Larch and Salto’s main reasoning that the PSB is likely to give an exaggerated measure of discretionary policy. At the same time, Larch and Turrini (2009) admit that ‘despite its many downsides [...] the cyclically-adjusted budget balance (CAB)<sup>76</sup> remains to date one of the key indicators for the analysis and conduct of fiscal policy making, in particular in the EU fiscal surveillance framework’.

### **Fiscal policy measures used**

Given the criticism facing the PSB measure it seems unwise to base the entire empirical analysis on one indicator. Scrutinising fiscal policy and its coordination, this thesis will consider four common indicators of fiscal policy (see also Table 5.1):

- 1) the change in the budget balance ( $\Delta BB$ )
- 2) the change in the primary budget balance ( $\Delta PB$ )

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<sup>76</sup> SB and CAB denote the same variable.

- 3) the change in the structural balance ( $\Delta SB$ )
- 4) the change in the primary structural balance ( $\Delta PSB$ )

Additionally, I will consult the available figures on stimulus packages. These crucially rely on subjective policy evaluation to determine which fiscal measures qualify as crisis measures and which not. Adopting a centripetal measurement approach has three advantages. First, it is a welcome robustness check for empirical analyses. To address the quality issues generally signalled in connection with the measurement of fiscal policy outcomes – available data are not based on an unanimously agreed methodology – I used different measures to assess the robustness of results. The four measurements then each account for a distinct, albeit overlapping and correlated, aspect of fiscal policy. What is more, when scrutinising fiscal choices during 'hard times', to paraphrase Gourevitch (1986), it seems undesirable to completely purge these 'hard times' from the fiscal outcome variables. I am specifically interested in the role of automatic stabilisers (see below) and the varieties of fiscal policy choices along a sliding scale of discretion. Are fiscal policy outcomes, which are thought to carry little discretion, driven by different determinants than those who are based on purely discretionary policy choices? Second, this strategy enables comparison with other studies on fiscal outcomes which predominately use the change in budget balance for fiscal performance or the change in the cyclically adjusted primary deficit for the discretionary element of public finances. Third, data for stimulus packages is available for 2009/2010 only; relying exclusively on this measure would therefore reduce the temporal scope of the empirical investigation. What is more there is evidence that policy-makers responded to the economic downturn already in 2008. The average budget deficit in the EU worsened in 2008 to 2.3 per cent of GDP from 0.8 per cent in 2007 (Public Finances in EMU, 2009) and we cannot simply assume that this was the result of non-discretionary fiscal policy. Excluding the year 2008 risks presenting an unduly shortened analysis of fiscal response strategies.

## **Intentionality and fiscal policy**

One of the main problems for the study of fiscal stimulus policies is that of intentionality. For theoretical purposes it is worthwhile to disentangle the discretionary and intentional elements of public spending. In a stylised presentation of the fiscal impulse and its components, the ECB (2010) attempts a methodical dissection of fiscal policy actions (Figure 4.1). The resulting schema differentiates between discretionary and non-discretionary fiscal policy actions, between policy measures and non-policy effects, as well as non-crises related measures and measures taken in response to the crisis. A glaring problem of this Figure is that it ignores the budgetary implications of the financial sector bailouts. While this albeit flawed desegregation is a useful conceptual exercise, this characterisation does not yield concrete measurements due to a lack of data availability (where it could be collected) and measurability (where it could not be collected). The former pertains to policy measures and non-policy measures, as well as to the definition of automatic stabilisers. Both touch upon the distinction between crisis and non-crisis policies. Notwithstanding empirical practicalities, the ECB schema displays some of the key challenges inherent in the discussion of fiscal policy: How ‘automatic’ are automatic stabilisers? Does public expenditure *during* the Great Recession amount to expenditure *in response to* the crisis? How should one account for public expenditure related to the financial sector?

*Insert Figure 4.1 here*

## **On automaticity and discretion**

The notion that automatic stabilisers are driven by forces which are outside the control of fiscal authorities is not uncontested in the literature. Even prior to the Great Recession, it was argued that the line of demarcation between discretionary fiscal policies and automatic fiscal stabilisation was not as sharp as generally thought



(DerOose *et al.* 2008). First, at least in the context of the 27 EU countries analysed, any expenditure has to be approved by the executive and the legislature and should therefore be, at least in theory, mutable.<sup>77</sup> The allegedly structural component may be systematically linked to the economic cycle. For example, the government may systematically raise tax rates whenever activity rises above potential and reduce them whenever it falls below potential. During the Great Recession a number of countries had actually increased the size of the automatic stabilisers. Belgium, the Netherlands and Italy, for instance boosted unemployment benefits during the crisis (Saha and Weizäcker 2009). Looking at the composition of fiscal packages over the 2008 to 2010 period, an OECD (2009) study finds that various EU countries implemented tax measures to mitigate the economic fallout of the Great Recession. The reduction of social contributions in Germany and Finland, for example, amounted to 0.7 and 0.4 per cent of 2008 GDP respectively. These and other changes in the tax and benefit structure relating to automatic stabilisers were counted in the aggregate of fiscal stimulus packages by both national and European authorities. This is not to suggest that all spending measures are alike and equally readily changeable. There is ample evidence in the literature that entitlement spending for instance faces higher institutional constraints than public investment (e.g. Breunig and Busemeyer 2011). Instead this section seeks to challenge the dichotomous notions of discretionary and automatic. The former ECB President Trichet (2008) stressed that ‘countries with budgetary room for manoeuvre can let automatic stabilisers operate freely’. Yet this concession implies that those countries without fiscal room for manoeuvre should curtail their automatic stabilisers and accordingly that automatic stabilisers are not an inevitable spending item in the annual budget.

What is more, it seems reasonable that in the design of discretionary stimulus programmes, policy-makers would be aware of the costs and effects of automatic stabilisers, although not necessarily with the focus of whether the spending item

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<sup>77</sup> Irrespective of the difficulties associated with entrenched welfare states; see Clayton and Pontussen (1998).

should be grouped as ‘automatic’ or ‘discretionary’. De Castro *et al.* (2011) argue that countries with large automatic stabilisers provide a sizeable counter-cyclical economic impulse without the need for recourse to additional discretionary measures. Consequently, when comparing crisis responses based solely on the adoption of stimulus packages, the conclusion might be drawn that government is fiscally inactive, when, in fact, if the financial flows stemming from the working of automatic stabilisers were also accounted for, the conclusion could be quite the opposite. In this regard, answers to questions of free-riding and group orientated behaviour are likely to diverge depending on the fiscal measure used.

Yet how much did automatic stabilisers contribute to cushioning the blow of economic downturn? Girouard and André (2005, updated in OECD, 2009) measure the overall cyclical sensitivity of the budget to the economic cycle as the difference between the cyclical sensitivity of four categories of taxes (personal, corporate, indirect, and social securities contribution) and on current primary expenditure, weighted by their respective shares of GDP. Crucially, budget elasticities are said to change little over time and one single weight indicator is used for the assessment of the 2008 to 2010 period. A budget elasticity of 0.51, as in the case of Germany, means that the budget balance declines about half a per cent in response to a negative output gap of one per cent. The contribution of automatic stabilisation is therefore dependent on the strength with which different budget items respond to cyclical changes and the size of output gaps. So is there strategic substitution between fiscal stimulus policies and automatic stabilisation? Did member states design less ambitious stimulus policies, knowing that they have large automatic stabilisers that will support aggregate demand? In light of the controversy surrounding the operation of automatic stabilisers, there is surprisingly little evidence that Member States with larger automatic stabilisers implemented smaller stimulus programmes. Fuest *et al.* (2010) show that automatic stabilisers are largely unrelated to the size of fiscal stimulus packages adopted. Figure 4.2 replicates their findings using the measurement of Girouard and André (2005, updated in OECD 2009). However when

running the same correlation with an indicator used by the European Commission,<sup>78</sup> results are different and in fact suggest a statistically significant *negative* relationship between the size of automatic stabilisers and fiscal stimulus programmes of individual EU countries. In the words of the Commission, Member States agree to coordinate a ‘budgetary stimulus package’ or a ‘budgetary impulse’. A budgetary stimulus is arguably a change in expenditure or revenue policies that boosts aggregate demand regardless of whether it is considered ‘discretionary’ or not. However in setting a tentative stimulus threshold the EERP explicitly states that that 1.2 per cent of spending should be considered, in addition to the working of the automatic stabilisers.

*Insert Figure 4.2 here*

One interviewee in the Commission pointed out that ‘discretionary spending is not a statistical term but for Ecfin to decide, what is what’ (author interview, May 2011). This means that different understandings are likely to prevail with regards what counts as discretionary and what does not. However since this thesis considers fiscal policy coordination within the EU, the year-to-year change in PSB and the PB are therefore useful measurements to investigate Member States fiscal policies in the light of the EERP and related communications. Doing so relies on the filtering out of non-discretionary spending items. This approach is less sophisticated than other statistical smoothing techniques used to extract the cyclical component of budgetary categories. At the same time, given the substantial role of automatic stabilisers, – the automatic stabilisation provided was greater, overall, than the discretionary measures (Public Finances in EMU 2010: 22) – it would be short-sighted to ignore their impact, especially when evaluating free-riding. It is therefore sensible to include a measurement of the cyclical balance that takes the working of automatic stabilisers into account.

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<sup>78</sup> The European Commission (2010) calculated the change in the output gap multiplied by the expenditure-to-GDP ratio (used as a proxy of the semi-elasticities of the budget balance).

## Crisis policies?

The second question relates to the intentionality of policies during the Great Recession. A case in point can be found in Germany, where the change of the commuter tax allowance (*Pendlerpauschale*) and the change of tax deductibility of social security contributions reduced government revenue by about 0.8 per cent of GDP (Zohlnhöfer 2011). Both of these changes were not made deliberately by the German government, but due to rulings of the Federal Constitutional Court. The government chose to abstain from offsetting this fiscal effect and did not re-finance the thus-created expenditures. This led to the decision by German and European authorities to count these expenditures under the discretionary fiscal stimulus package.

Are fiscal policies during a crisis necessarily policies in response to the crisis? There are various examples of dubious ‘crisis labelling’ in the EU. Armingeon (2012: 9) points out that under this German accounting, ‘about two-thirds of the [German] “gross” stimulus was not due to a crisis-related political choice but resulted independently from [sic] economic circumstances’. He goes on to argue that some Austrian programmes had already been introduced in the Spring and September of 2008 before the crisis hit the real economy, and were part of a policy bundle seeking to increase real household income prior to national elections. During the crisis these measures remained in force, yet their original design and implementation were not linked to the Great Recession. Another example can be found with respect to education spending in Malta. The increase in expenditure related to education (amounting to 0.34 of GDP; MinFin 2009) was presented as stimulus spending, whereas it arguably had little to do with the economic and financial crisis, but was ‘already planned and sold as part of the electoral campaign in the previous year’ (author interview, April 2011). A substantial proportion of Luxembourg’s stimulus consisted of measures that ‘had already been agreed to before the crisis and consisted of purchasing power increases to compensate *ex post* for faster inflation in

2008 due to high energy prices' (Watt 2009: 12). Similarly, Spain's stimulus programme can in large part be traced back to the fulfilment of election promises in the spring of 2008 (Burnett 2008). Concerning the intentionality of crisis policies, a degree of uncertainty will remain unresolved. Indeed as depicted in Table 4.1, the data on these stimulus packages vary considerably depending on the source. Some of these variations can be explained by the fact that some governments labelled spending decisions taken before the crisis as elements of the crisis package, or by other governments labelling EU funds as part of the national fiscal package (Armingeon 2012).

*Insert Table 4.1 here*

### **Interventions to support financial institutions and financial markets**

The third question concerning the impact of the financial sector bailout is a reminder that the Great Recession started as a financial crisis. Government interventions in the financial sector had a considerable impact on public finances. To clarify any issues about how to account for measures undertaken in the context of the financial crisis, Eurostat published a decision on 15 July 2009. One can distinguish between three kinds of measures for accounting purposes. First, measures which have to be recorded as expenditure and will contribute to the deficit (direct costs). Second, measures such as loans and securities other than shares that will only appear as an increase in government debt (liabilities) and third, measures that are outside the government books and as such do not impact on expenditure or government debt (contingent liabilities). Pontussen and Raess (2012: 24) brush away concerns over the bias introduced by the support given to financial institutions and financial markets: 'Suffice it to note, at this point, that most of the support for the financial sector [...] does not show up in national accounts as current spending and consequently is not part of the estimates of fiscal stimuli [...]. In this sense, fiscal stimuli and financial bailouts can be treated as independent policy choices.' (*ibid.*

27). Table 4.2 presents the correlation between financial sector interventions and fiscal crisis responses. The financial sector interventions take on a negative value if costs occurred and a positive value if the revenue from the bailouts (for example via interest payments received and gains from share price increase) exceeds the costs. Contingent liabilities and liabilities, similar to the direct costs, are correlated with larger stimulus spending. The correlation results with the Commission's stimulus figures (virtually identical for the ECB's estimation) display no statistical significance. This is in contrast to the correlations with this thesis for main variables ( $\Delta BB$ ,  $\Delta PB$ ,  $\Delta SB$ ,  $\Delta PSB$ ). Overall results suggest that the direct costs of the financial bailouts are negatively correlated with stimulus activities in response to the Great Recession. On the contrary, contingent liabilities and liabilities are positively correlated with fiscal crisis measures, perhaps indicating the severity of the financial and subsequently economic crisis and thus the perceived need to stimulate domestic demand. Results using the changes in the budget balance differ. This should not come as a surprise as this is the only measurement where financial sector costs are not filtered out. While I agree that the bulk of financial sector interventions do not show up in the deficit headline figures, the evidence presented here suggests that Pontussen and Raes' (*ibid.*) claim of 'independent policy choices' should be taken with a grain of salt.

*Insert Table 4.2 here*

### **Hidden interventions**

Financial sector interventions recorded as liabilities do not show up in this study's primary expenditure based measurement, nor do financial sector interventions classified as contingent liabilities show up in any of the measurements used. The two components recorded as liabilities/debt are: 1) loans incurred (directly or indirectly) by government in order to finance various interventions, and 2) debt securities issued by government to finance the interventions. The latter forms the bulk of government

liabilities, as EU governments financed their rescue measures predominantly by new issuances of debt securities – more than 72 per cent of all debt issuances from 2008 to 2010 (Eurostat 2012). The third part of the rescue package comprises government contingent liabilities.<sup>79</sup> After the aforementioned decision, contingent liabilities pertaining to the financial crisis are not recorded in national accounts. In other words, they neither impact on expenditure levels nor on government debt. Given the increased debt burdens due to rescue operations in the financial sector, this study does not consider the change in general government debt in percentage of GDP to capture a country's 'fiscal performance'. According to Hallerberg *et al.* (2009: 77) this conventional measurement has the advantage that 'everything the government does appears on these accounts, and that means that they are much less subject to direct accounting tricks'.<sup>80</sup> In the context of crisis interventions, this strength is then also its weakness, in that this study is not primarily concerned with the 'fiscal bill' of the financial sector interventions.

The main concern stemming from the financial sector interventions is that these policy measures might interact systematically with the variables determining the state of public finances as well as, consequently, fiscal policy coordination. Various factors should however limit such bias if it exists. First, relying on the primary balance on the expenditure side does filter out 80 per cent of the interventions related to the reported deficit (Eurostat 2012). The short-term net impact of the various measures in support of the financial sector has been relatively small, amounting to less than an increase in deficits of 0.1 per cent of GDP for the EU27 as a whole as of 2011. Secondly, this study controls for the impact of financial sector interventions. Government interventions aimed at the financial sector and at the real economy are

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<sup>79</sup> Concerning government interventions in the financial crisis over 2007-2011, the lion's share of contingent liabilities reflect the guarantees granted on the financial institutions' assets and liabilities (nearly 79 per cent of the total value). The remaining contingent liabilities concern the value of securities issued under liquidity schemes, with around 15 per cent, and the operations of special purpose vehicles, with around 6 per cent (Eurostat 2012).

<sup>80</sup> On accounting tricks after the introduction of the euro see von Hagen and Wolff (2006), Bernoth and Wolff (2008).

not independent policy choices, but almost certain to influence one another. To control for the impact of the financial crisis should reduce the exogenous noise of the bailout blowing up expenditure levels out of sync with the usual determinants of government spending suggested in the literature. Thirdly, by controlling for the general economic climate, the impact of the financial crisis is also accounted for. On a related note, the cyclically-adjusted measure takes into account the magnitude of the crisis and is closely linked to the financial fallout as it is well documented that financial crises lower potential output (Furceri and Mourougane 2013).

### **Measuring compliance**

Empirically, fiscal policy coordination will be analysed by proxy. There is no clear variable measuring compliance<sup>81</sup> with the EERP. Instead, by identifying the determinants of fiscal policy outcomes during the Great Recession, this thesis sheds light on the conditions of fiscal policy coordination. Specifically I will test the free-riding hypotheses as outlined in the previous chapter. Fiscal free-riding is defined here as the opposite of group-oriented behaviour. This approach carries the advantage that whereas compliance with any intergovernmental agreement on public finances is not a clear indicator that these rules shape fiscal policy choices, free-riding policies are a sign that they do *not*. In line with the preceding discussion on intentionality it is easier to find negative evidence for the collective action outcome (free-riding).

A Member State could very well be in full compliance with the stipulations to achieve fiscal policy coordination, without these intergovernmental fiscal rules and agreements actually shaping its choice of actions. A scenario where a Member State sets fiscal policies that happen to be in accord with EU agreements is difficult to distinguish from a scenario in which a Member State decides on a set of fiscal

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<sup>81</sup> Compliance generally denotes behaviour that conforms (or comes into relative conformity) with prescribed or proscribed behaviour (Young 1979).



policies *because* of EU agreements.<sup>82</sup> This leaves us with the problem of observational equivalence, a term usually associated with the Principal-Agent literature (Weingast and Moran 1983: 767, Epstein and O'Halloran 1999: 24).<sup>83</sup> Understanding whether EU agreements mattered for fiscal crisis responses is especially relevant in the context of intergovernmental, deliberately vague policy commitments which were tailored to the needs and demands of Member States. By including both EU and non-EU countries in this analysis, it will be possible to test whether EU Member States' fiscal responses to the Great Recession differed, all other things being equal.

Even though I do not empirically test for the drivers of compliance due to a small sample size<sup>84</sup>, it is illustrative to determine which countries complied with the EERP and which did not. The yardstick for free-riding is taken from the EERP, with its overall stimulus threshold of 1.2 per cent of GDP.<sup>85</sup> Any compliance measurement is problematic if not considered *vis-à-vis* a country's fiscal space. Again, the EERP clearly states that 'the budgetary stimulus should take account of the starting positions of each Member State. It is clear that not all Member States are in the same position.' In chapter seven I will examine the link between fiscal responses to crisis and a country's fiscal space in detail. Consequently, fiscal policy coordination in the EU is about the discord between the positive linkage of the severity of the crisis and

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<sup>82</sup> A related question asks whether non-compliance with the EERP is intentional or not. In his study of the domestic ratification of international agreements Putnam (1988: 438) distinguishes between *volitional* and *non-volitional defection*. Accordingly, involuntary defection refers to the behavior of an agent who is unable to deliver on a promise because of failed ratification. Haggard and Simmons (1987: 515) locate the reasons for such defection on the domestic level, 'it is not the result of calculating unified actors, but the outcome of domestic political conflicts which no single actor can control'. Non-volitional defection has been the focus of the management approach of the compliance literature, assuming that states are prevented from complying with international agreements due to the lack of sufficient state capacities (various types of capital or infrastructure), ambiguous definitions of norms, and inadequate timetables (Chayes and Chayes 1993; Haas 1998).

<sup>83</sup> Both cases of non-volitional cooperation and non-volitional non-cooperation are instances where observational equivalence poses a problem to the researcher.

<sup>84</sup> The EERP does not give annual targets, but merely an overall target that leaves us with 27 observations.

<sup>85</sup> Binary compliance approaches to public finance outcomes can be found in *inter alia* Hughes Hallet and Lewis (2008) or LeMay-Boucher and Rommerskirchen (2014). A measurement of *relative* compliance is suggested by Hallerberg *et al.* (2007).

the size of the stimulus. Specifically because countries experiencing a more severe recession are also suffering from a curtailed fiscal space, their ability to engage in stimulus spending is reduced. Group-oriented behaviour would see those countries with more fiscal space also shouldering more of the stimulus effort. It is here that coordination would live up to the textbook definition of ‘negotiated mutual adjustment that causes states to pursue different policies than they would have chosen had policy-making been unilateral’ (Webb 1995: 11).

### **Compliance with the EERP**

Table 4.3 summarises the non-compliant Member States according to the three main (and by far most complete in terms of coverage) sources for the estimation of the size of stimulus packages. The only common ‘laggard’ identified by all three sources is Greece, whose virtually non-existing stimulus packages should come as a no surprise in the light of the substantial economic hardship and consolidation pressures during the Sovereign Debt Crisis. Romania and Lithuania are not included in the ECB and OECD evaluation. However, there is little doubt that Romania did not implement a stimulus package amounting to 1.2 per cent of GDP. The original Commission estimation (European Commission 2011) puts the figure at 0.5 per cent, whereas the Council Opinion on the updated Convergence Programme of Romania (COU 2010) states that the stimulus measures amounted to 0.2 per cent of GDP in both 2009 and 2010.<sup>86</sup> Romania was hit hard by the financial crisis; as financial market participants grew more risk averse, Romania's large internal and external imbalances lead to a marked fall in capital inflows, causing the exchange rate of the new leu (RON) against the euro to depreciate by more than 30 per cent between August 2007 and January 2009. In the spring of 2009 this downturn caused the Romanian authorities to apply to the EU, the IMF and other international financial institutions for financial assistance. This assistance was conditional on fiscal consolidation and given the tight budgetary constraints, Romania's comparatively small stimulus package was

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<sup>86</sup> Council Opinion on the updated convergence programme of Romania, 2009-2012

welcomed by the European Commission (see Convergence Programmes 2009, 2010). Similarly, Lithuania faced budgetary difficulties that would have made the implementation of stimulus measures problematic. The Concluding Statement of the IMF Mission of December 2008 (IMF 2008) noted that global financial markets were effectively closed and domestic borrowing options severely limited by a lack of liquidity. This shock has been compounded by the decline in export demand from its recession-hit trading partners. In light of these events, the IMF recommended upfront fiscal adjustment to increase confidence in the currency board arrangement. It was judged that Lithuania did not have the scope for fiscal stimulus available to some other countries in order to counter the downturn.

*Insert Table 4.3 here*

The OECD and IMF measures are in agreement as to the stimulus measures in France, Italy, Portugal, and Ireland being below the 1.2 per cent threshold (similar estimates are found in Watt (2009)). The OECD does not provide estimates for Slovenia and Cyprus. The 2010 Stability Programme put together by the Slovenian authorities argues that the discretionary policy response was small given the limited effectiveness of stimulus spending in a small and very open economy. Here the total discretionary policy measures influencing the real economy directly (employment and productive capacity) were said to amount to 254 million EUR, or around 0.7 per cent of GDP. However according to the programme, measures to support the economy laid down in the government's stimulus packages, as well as expansionary measures taken before the onset of the crisis (mainly tax relief for companies), are said to add up to almost 2 per cent of GDP. Similarly, in its Article IV review of the Slovenian economy in 2009, the IMF estimated the size of the fiscal stimulus package at 2.1 per cent of GDP. The difference between these estimates and the ECB estimation is due to the inclusion of the tax stimulus previously adopted and being implemented in 2009. Again this touches upon the question of intentionality. There is an argument to be made that the EC's stimulus measure should be accepted because

a) all official documents, be it from Slovenian or EU officials, are very transparent about the inclusion of the tax relief for companies; b) Slovenian authorities account for the relief as a deliberate policy choice despite being agreed in early 2008; and c) the Stability and Convergence Programme includes the relief under the ‘discretionary stimulus measures’.

The high stimulus figure for Cyprus given by the EC (5.1 per cent of GDP) comes as somewhat of a surprise given that Cyprus experienced the mildest recession in the eurozone in 2009, with a fall in GDP of just 1.9 per cent. The IMF also provides a high estimate of the Cypriot stimulus at 4 per cent of GDP, composed of permanent increases in wages and salaries (1.6 per cent of GDP), social transfers (1.6 per cent of GDP), and public investment (1.4 per cent of GDP) (IMF Country Report No. 11/331). However all communication under the Stability and Convergence Programme, including the reports by Cypriot authorities, give 1.5 per cent of GDP as the official figure. This figure, although much closer to the ECB’s estimation, is also above the EERP threshold.

In contrast to the OECD and the EC estimates, the ECB reports both Ireland and Belgium’s stimulus packages as less than 1.2 per cent of GDP. Based on additional official reports (notably the Stability and Convergence Programmes) and Watt’s figures (2009), it appears that the Belgian stimulus programme fell below 1.2 per cent of GDP. In the Stability Programme, Belgian officials confirm this, justifying the comparatively small expansion (0.9 per cent of GDP) by stating that ‘in accordance with the European Commission’s recommendations, the stimulus plans put into effect have been more limited owing notably to the inherent characteristics of Belgium’s open-market economy’ (Belgium-SC 2010). Along similar lines, in its Assessment of the Stability Programme, the Commission points out ‘that as a result of the openness of the economy, foreign packages should also contribute considerably to the recovery of the Belgian economy’ (ECFIN/52791/09-EN). Belgium’s country specific circumstances hardly warranted a large fiscal expansion,

‘in particular [given] the very high and rising debt-to-GDP ratio, the above-average cost of ageing and considerable contingent liabilities following the operations to stabilise the financial system, the fiscal room for manoeuvre of Belgium can be characterised as limited’ (*ibid.*). However the Council Opinion on the updated Stability Programme of Belgium sanctions the fiscal stimulus package as an ‘adequate response to the downturn’. In addition to these economic problems, the on-going difficulties in forming a government during the turmoil of the Sovereign Debt Crisis meant that Belgium was caught in political turmoil without federal government from June 2010. The lack of government did not however startle market participants. This may be due to the fact that, as Hooghe (2012) argues, regional governments, the European Union, public service managers and Members of Parliament expanded the scope of their authority and thus filled the policy vacuum. In addition, Bouckaert and Brans (2012: 174) show that from a fiscal standpoint the lack of executive did not lead to a budgetary deterioration. On the one hand, major structural policy reforms, such as pension systems and social security, energy supply, employment and labour market suffered from the ‘interregnum’ of the caretaker government. On the other hand, the budgetary control mechanism of ‘provisionary twelfth’ authorized only one-twelfth of the previous budget to be spent monthly in the absence of a newly approved budget. This meant that in the absence of government no additional expenses could be approved, which resulted in an improvement of the budget balance.

## **Conclusion**

This chapter has located the four main measurements for fiscal policy and its coordination in times of economic and financial crisis. None of these measurements is without fault, as the discussions on policy intentionality and automaticity, as well as the accounting of financial sector rescue operations, have suggested. But taken together they are valid proxies for fiscal policy choices and the analysis of fiscal policy coordination. As such this study adopts a centripetal measurement approach.

Different measurements can provide answers to different questions pertaining to fiscal policy during the crisis, which suggests caution in choosing the right variables (or ignoring additional variables which could be considered). At the same time, different measurements of fiscal policy may also yield different answers to the same question. The narrower a measurement the smaller the fiscal activism of government estimated. Public documents on fiscal policy coordination regularly pick and chose from the different measurements, depending on the nature of their evaluation. For example when presenting the crisis measures, a 2010 EU (European Commission 2010) publication used the broad measure of budget balance (including interest rate payments), stating that ‘over 2009-2010, the additional support to economic activity as measured by the change in the budget balance is estimated to amount to 5.0 per cent of GDP.’ Indeed, since there is little consensus on the definition of crisis measures, or fiscal support, it seems sensible not to rely solely on a single indicator. Testing the three main hypotheses with different fiscal measurements of varying scope should render the results more robust and help to avoid any bias in the evidence presented.

It is important to add that by analysing fiscal policy coordination during the Great Recession, this study does not venture into the thorny field of assessing the exact size of the impact that fiscal measures had on aggregate demand; I focus on the input side (the changes in government finances) and not on the output side (its effect on macroeconomic developments). The extent to which fiscal policy is effective in supporting growth recovery, both in the short term and in the long term, is subject to much debate (Jansen *et al.* 2008). Whilst arguably relevant for the production of the public goods in question, a study of the output side would be beyond the remit of this investigation. A focus on the input side is not only empirically more feasible, but also the relevant approach for the study of fiscal policy coordination. The EERP (similarly to the rules of the SGP) makes suggestions about the size of stimulus spending and not about the size of the impact of this expenditure. In so doing, the

effect of stimulus policies will be considered at face value – that is to say, in terms of the impact they had on changes in public finances.

## **CHAPTER 5: THE POLITICAL AND ECONOMIC DETERMINANTS OF FISCAL CRISIS RESPONSES**

### **Introduction**

This chapter seeks to answer the question of whether fiscal policy choices during the Great Recession were characterised by a so-called ‘deficit bias’. In so doing, it identifies the determinants of public finances in times of economic crisis. How do different determinants of fiscal policy affect group latency by either increasing or decreasing public spending? Specifically, I will test the sub-hypotheses related to the spending and borrowing bias of profligate governments emanating from the democratic political process as presented in chapter three. Informed by the political economy literature on public finances, this investigation is guided by the notion that fiscal outcomes do not emerge in a political vacuum. Instead, they are influenced by a complex battery of factors describing the political environment within which actors bargain for their favoured policy outcome – as Adler (1991: 53) points out, ‘the environment does not “instruct” policy-makers, it challenges them’. Accordingly this chapter seeks to elucidate the choices and constraints of the fiscal politics of ‘hard times’.

The following discussion is based on 81 observations. This is justified by the fact that it represents a ‘complete population’ in the sense that all EU countries and the main years of the Great Recession during which the EERP applied (2008-2010) are included. Empirically I augmented the numbers of observations with numerous interactions of each variable of interest with a pre- and per- crisis dummy. Doing so for the 1994 to 2010 period, I reject the hypothesis of parameter poolability (i.e. the poolability of the data). Evidence for this claim can be provided in form of a Chow test for structural change across time, which indicates that the sets of coefficients for all the specifications are significantly different for the post and pre crisis years.



Similar studies on fiscal policy during the economic and financial crisis are likewise left with relatively few observations (e.g. Armingeon 2012; Cameron 2012).

This chapter is organised as follows: I start with a presentation of the data and methods of the empirical analysis, identifying the operationalisation of dependent and independent variables that were developed in chapters three and four. Subsequently the research design and empirical methods employed are discussed. The following section presents the empirical findings and discusses various robustness tests. In the discussion, three key findings are considered in greater detail. These are the timeliness of automatic stabilisers, the impact of political fragmentation and the role of fiscal conservatism, both for national and EU policy-makers. Here the empirical results are compared to the existing literature and analysed vis-à-vis additional documents and interviews on the politics surrounding fiscal policy coordination during the Great Recession.

## **Data and methods**

This section discusses the empirical research design for this chapter, starting first with the dependent and independent variables and ending with the discussion of the appropriate estimation techniques. The model specification is as follows:

$$\Delta \text{fiscal outcome} = \alpha + \beta_1 \text{L.GDP}_{i,t} + \beta_2 \text{L.debt}_{i,t} + \beta_3 \text{L.AS}_{i,t} + \beta_4 \text{Bailout}_{i,t} + \beta_5 \text{Election}_{i,t} + \beta_6 \text{Herfgov}_{i,t} + \beta_7 \text{Herfopp}_{i,t} + \beta_8 \text{Left}_{i,t} + \varepsilon_{i,t}$$

The following paragraph describes the variables used to test the assumptions concerning the determinants of fiscal policy choices. Summary statistics for these variables can be found in Table 5.1. A definition of these variables, including sources, together with other key variables used in this thesis is listed in the Appendix in A1.

*Insert Table 5.1 here*

*Fiscal policy:* As mentioned in the previous chapter, the strategy for capturing a country's fiscal responses to the crisis will be to test four variables separately; the change in budget balance (BB), the change in the primary balance (PB), the change in the structural balance (SB), and the change in the structural primary balance (PSB).

*Economic conditions:* Economic conditions are controlled for in the estimations. First, I include the lagged GDP growth rate (*GDP*).<sup>87</sup> Economic growth is likely to impact on fiscal choices. Low (or even negative) rates of economic growth tend to increase budget deficits by reducing revenue and increasing expenditure (notably in the context of unemployment benefits). What is more, the political pressure to bring about economic growth via fiscal stimulus programmes increases as economic conditions deteriorate. Second, the lagged debt to GDP ratio (*debt*) represents a country's past fiscal legacy as well as its constraints for future spending in light of fiscal sustainability. Third, the lagged size of automatic stabilisers (*AS*) controls for both the budgetary impact of welfare state provisions and budget elasticities, and for the fact that discretionary fiscal policies are influenced by the size of existing crisis provisions in the form of automatic stabilisation. Its measurement follows the European Commission and takes the change in the output gap multiplied by the expenditure-to-GDP ratio (used as a proxy of the semi-elasticities of the budget balance) (Data Source: Ameco and European Commission 2010).

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<sup>87</sup> Lagged variables are used to circumvent the endogeneity problem of contemporaneous macroeconomic variables which raises doubt as to the validity of the estimates and may create biases. Initially I attempted to instrument GDP growth as well as the debt levels with their lagged variables as well as US GDP and debt levels. As Hallerberg *et al.* (2007: 341) note it is 'notoriously difficult to instrument changes'. Relevant tests indicate the strength of the instruments is fairly weak. At the same time a Durbin-Wu-Hausman test confirmed the endogeneity of both variables (see Table A5.2 in the Appendix). Similar to Armingeon (2012) I therefore use the lagged variables.

*Financial crisis:* The variable *Bailout* records the consequences of the bank and other market support operations by public authorities. Including this variable controls for the fact that stimulus measures and financial bailouts are likely to be interrelated policy choices. Specifically, it measures the direct costs of these interventions in per cent of GDP as recorded by Eurostat (2012). A negative value records costs, whereas a positive value indicates revenue stemming from the financial sector interventions.

*Elections:* The variable *Election* is a dummy variable, equal to 1 if there was a legislative election at the national level in a given year (Keefer 2010).

*Government fragmentation:* To measure the strength of the executive I include the variable '*Herfgov*', which indicates the probability that two deputies picked at random from among the government parties will be of different parties. This variable has a potential range from 1 (government is composed of a single party) to close to 0. This variable is found in Keefer (2010).

*Opposition fragmentation:* Analogous to the variable above, I include a corresponding measure for the strength of the legislative opposition, '*Herfopp*', which indicates the probability that two deputies picked at random from among the opposition parties will be of different parties. This variable, which is also found in Keefer (2010), has a potential range from 1 (the opposition is composed of a single party) to close to 0 (every opposition seat in the legislature is held by a different party).

*Government ideology:* To account for the executive party/parties orientation with respect to economic policy, I include a variable for 'right' and 'left' governments. '*Right*' takes the value one for parties that are defined as conservative Christian democratic, or right-wing; '*Left*' takes the value one for parties that are defined as

communist, socialist, social democratic, or left-wing. Centre is omitted. Data comes from Keefer (2010) (based on EXECRLC).

### **Econometric issues**

Due to the small sample of countries and the limited number of years included, the use of panel data estimation techniques with fixed or random effects, may be not appropriate. What is more the existence of several dummy variables that do not change over time, means that the use of fixed effects is not feasible. This is why I prefer to use pooled ordinary least squares (OLS) estimation technique.<sup>88</sup>

A pooled cross section (where observations for all countries and for all periods are pooled in one cross section sample) is analysed much like a standard cross section, except that it accounts for variation across time. ‘Pooling’ offers at least two advantages compared to either a pure cross section or a pure time series analysis. First, as the number of observations increases so do the degrees of freedom. This makes it possible to estimate more fully specified models and to reduce the potential problem of omitted variable bias. Second, pooling makes it possible to control for exogenous shocks common to all countries (by controlling for time effects). The pooling procedure was made popular by Beck and Katz (Beck & Katz 1995), also called the ‘de facto Beck-Katz standard’ (Plümper *et al.* 2005: 327) due to its influence on subsequent research. It includes a lagged dependent variable, time and unit dummies. The analysis of pooled data is econometrically more problematic than a pure cross-section analysis due to that fact that observations from the same countries are not independent. I use panel corrected standard errors to address this potential violation of the standard OLS assumptions.

The OLS estimator proposed by Beck and Katz (1995) is known to be biased if errors are autocorrelated. To eliminate serial correlation of errors, the authors

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<sup>88</sup> Using the command `xtpcse` in stata.

recommend adding the lagged dependent variable to the right-hand side of the equation, which in almost all cases suffices to get rid of autocorrelation. In the public finance literature the inclusion of a lagged dependent variable is a common feature, as authors often point to the path dependency of fiscal policy choices (e.g. Davis *et al.* 1966). In fiscal policy studies the lagged dependent variable is frequently found to be significant and included for theoretical as well as methodological reasons (e.g. Hallerberg *et al.* 2009). As Kittel and Obinger (2003: 24) point out, it seems appropriate to assume persistency, particularly in the context of the comparatively large European welfare states. Welfare budgets are made with reference to the budget of the previous year and the largest shares of social spending (health care and old age pensions) tend to increase incrementally.

Analysing discretionary fiscal policies, there is reason to doubt the narrative of fiscal path dependency. Indeed over the years, Wildavsky's notion of 'budget incrementalism' (1964) has come under attack in research exposing the limited evidence of this account (for a review see Berry 1990). This thesis is mainly interested in explaining the variations of discretionary fiscal responses, which should reflect the felt needs and political pressures of the current year, as opposed to the previous year's. 'Sticky' expenditure and revenue is filtered out in both the SB and the PSB measure. From a theoretical point of view the inclusion of a lagged dependent variable therefore only makes sense for the cyclical indicators.

Given that our sample only covers three years, it is technically difficult to detect any serial correlation with confidence. I nevertheless test for it (Wooldridge 2002; Drukker 2003) and results indicate that autocorrelation is only an issue in one of the models (BB). This makes sense, since this measurement carries less 'discretion' than the cyclically adjusted and primary balance indicators, thus making it more persistent over time. Including a lagged dependent variable as suggested by Beck and Katz (1995) does not alter the results, nor does the inclusion of the lagged dependent variable improve the model's fit, as indicated by the  $R^2$  (see Table A5.1 in the

Appendix). This is an interesting finding in itself, suggesting that fiscal policy responses during the Great Recession were not driven by path dependency.

Pooled data from multiple countries observed over a number of years can cause problems when analysts attempt to apply the standard linear regression model. Panel heteroskedasticity (individual countries have their own error variances) and contemporaneous correlation of errors (cross-national phenomena such as stimulus policies that cause one country's errors to be correlated with the errors of other countries) generate biased estimation of standard errors if left uncorrected. I thus use standard errors that are corrected for these problems.

Having discussed broader methodological issues, the next two sections will consider measurement problems specific to this investigation; the first concerns the possible endogeneity of elections and the second addresses the appropriateness of the measurement of partisanship in the context of fiscal outcomes.

### **The endogeneity of elections**

Governments manipulating the timing of elections, calling elections early in the light of a climate favourable for the incumbent or delaying elections if approval ratings are low, may give rise to endogeneity<sup>89</sup> (e.g. Rogoff 1990). A further source of endogeneity might stem from unobserved factors. For instance, as Brender (2003) argues, both the timing of elections (the breaking up of government) and fiscal policies could be influenced by a variety of (unobserved) variables, such as social unrest, which are not included in our regression. What is more, looking at the election landscape of the Great Recession, it seems that in a number of instances early elections and public finances were interlinked. For example in September 2009, the then Greek Prime Minister Costas Karamanlis called for snap elections after

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<sup>89</sup> Endogeneity refers to the presence of an endogenous explanatory variable that is correlated with the error term either because of an omitted variable, measurement error, or simultaneity.

discontent with his government's handling of the unfolding economic crisis (*New York Times* 2.09.2009). In the same year the Hungarian Prime Minister Ferenc Gyurcsány surprisingly announced his resignation for similar reasons (*LaTribune* 24.03.2009). After protests in Riga over the worsening economic situation degenerated into riots, the Latvian prime minister resigned, defending of his austerity plans which were deemed necessary in the light of a €7.5bn bailout (*Financial Times* 20.02.2009).<sup>90</sup>

There is reason to assume that the endogeneity of elections should be a wider concern, and not only for the 2008-2010 period. Heckelman and Berument (1998) for example, find that election dates in Japan and the UK are endogenous. Analysing elections in both countries for the 1960-1990 period, the authors present strong evidence to support the notion that election timing is a function of the economy, rather than the macroeconomy, being driven by elections as often assumed by the political business-cycle literature. Whilst outside the period of empirical analysis here, this assessment seems to apply to the surprise election in 2011, when José Sócrates, the president of Portugal resigned because Portuguese opposition parties refused to approve a package of austerity measures (1.4.2011 *Financial Times*). One could just as easily argue that the timing of elections is determined by fiscal policy choices and not the other way round. This complex relationship makes it difficult to establish any direction of causality with certainty.

To deal with this endogeneity problem, similar to Wehner (2011), I therefore enter a new dummy variable which captures the number of years left in the electoral term of the current government as an instrument for actual elections. This instrument suggests itself; in all countries the electoral term is constitutionally determined (in the sense that there are term limits) and therefore difficult to manipulate. Thus, the assumption that the number of years left in the current term is exogenous to fiscal policy choices

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<sup>90</sup> However, government instability/absence in the Netherlands and Belgium during the same period is more complex and cannot be readily attributed to the turmoil of the financial and economic crisis.

is reasonable. At the same time, this instrument is correlated with the actual incidence of elections. This instrument is individually significant in the first stage; however, this does not in itself guarantee a successful identification in the second stage estimation. Testing for weak instruments, I use the Kleibergen-Paap rk F-statistic, a correspondingly robust version of the Cragg-Donald statistics. As Baum *et al.* (2007) note, the statistics obtained should be compared to 10, the conventional rule of thumb. The Kleibergen-Paap rk LM-statistics for overall identification allows us to strongly reject the null hypothesis that the equation is under-identified. Consequently, weak instruments may not be considered as a problem for all estimations. In short, the results suggest the model used is reliable. I then proceed to test for endogeneity in the variable estimated with instrumental variables; the results of this test show that the null cannot be rejected at a ten per cent level: endogeneity of the *Election* variable is not a problem in this analysis (see Table A5.2 in the Appendix). I therefore display results without instrumenting.

### **Conservatism as fiscal conservatism**

The inclusion of partisan variables in empirical studies on the determinants of fiscal outcomes is by now standard practice. An objection might be that the meaning of ‘left’ and ‘right’ varies markedly between Western and post-communist Eastern Europe. For historical reasons the left–right polarity certainly tends to be broader in the East, encompassing moral/cultural/historical as well as socio-economic cleavages (Sitter 2003). However East–West differences may be exaggerated; recent studies show ‘a remarkable (and increasing) similarity’ (Rovny and Edwards 2012: 70). Moreover, pan-European homogeneity within party families is very high: ‘The ideological identity of parties and voters is much stronger than the geographical identity. Genealogy trumps nationality’ (Camia and Caramani 2012: 75). In particular, the institution of direct elections to the EP and the cooperation and grouping amongst parties within the EP has increased the comparability of party families across the EU (Mair and Mugge 1998: 216).



A more relevant objection might then be that the right-left division is only able to give a crude notion of policy-makers' fiscal policy partialities. The misalignment between binary partisan positioning and nuanced macroeconomic preferences has been addressed particularly by studies on voters' preferences (e.g. Bohn and Inman 1995). For example, when analysing Swiss voters, Dafflon and Pujol (1999: 56) argue that 'the pertinent measure of conservatism for our issue ought to be directly related to the notion of fiscal conservatism which is different from the general notion of political conservatism'.

I accept the criticism of the arguably simplistic right-left choice. Is a more relevant measure of fiscal preferences available? One candidate would be the government's commitment to stimulus spending as recorded in the *Comparative Manifesto Project* (CMP) produced by Klingemann *et al.* (2006). This innovative database counts mentions in party manifestos that relate positively (or negatively) to particular policies. Specifically, I take the measurement for 'Keynesian demand management' as an indicator for the government's ideational outlook. This variable represents the percentage of sentences (with respect to the overall number of sentences) in the parties' election programmes which comprised of positive statements with respect to 'demand-oriented economic policy; economic policy devoted to the reduction of depression and/or to increase private demand through increasing public demand and/or through increasing social expenditures' (*ibid.* V409). If there is more than one party in a coalition government, the government's index value is an average of the separate index values of all coalition partners, weighted by their seats in parliament. Problematically, data (particularly for Eastern Europe) is incomplete and the observations are reduced to 64 – a cut of 20 per cent. The 'pro-stimulus' measurement is positively correlated with the two dichotomous right-left variables (for *left*  $\rho = 0.30$ , for *right*  $\rho = -0.24$ ). I will return to the impact of an expressed commitment to Keynesian demand management later in this chapter.

## The determinants of (discretionary) fiscal policy during the Great Recession

Table 5.2 presents the results of the main model. The findings suggest that the economic climate is a key determinant of fiscal policy outcomes. Indeed the macroeconomic variables together with the year and country dummies explain most of the variation (see Table 5.3). It is noteworthy that the jump in  $R^2$  is considerably larger for the SB and PSB models. Here, the addition of ‘political’ variables increases the  $R^2$  by .16 and .18 respectively. The interpretation is straightforward: the more discretion policy-makers have in their fiscal policy choices, the more important is the political landscape to these choices. The variable *GDP* captures the economic need for government intervention. All coefficients on this variable are negative, suggesting that policy-makers reacted to a severe economic downturn with less and not more stimulus spending, possibly due to a limited room for fiscal expansion (simple correlation estimates confirm this relationship both for the lagged and the contemporary GDP measurement). Its coefficient is largest for the measurements with the most discretion attributed (*PSB* and *SB*), which may be due to the fact that policy-makers here had larger freedom to actually curb spending. The variable *Debt* has the expected positive sign,<sup>91</sup> a result that points to the disciplining effect of high public debt burdens – a finding to which we will return again in chapters 6 and 7. The coefficient for automatic stabilisers shows a positive impact of automatic stabilisation on fiscal stimulus policies.

*Insert Table 5.2 and Table 5.3 here*

The coefficients of *Herfgov* and *Herfopp* indicate that while opposition fragmentation increases stimulus policies, the fragmentation of the government improves the fiscal position. A left-leaning government is found to lead to an

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<sup>91</sup> I also added the squared term of the *Debt* variable to control for non-linear effects, but its coefficient was not significant in any of the specifications, nor did it change any of the other coefficients. A RESET test confirmed the exclusion of both the quadratic and cubic term.

improvement in the budgetary position. I also included a corresponding variable measuring right-leaning governments. Here the coefficient was negative and statistically significant in all models. Since the interpretation of the findings remains unchanged and the models' fit did not improve, I parsimoniously excluded this variable in the light of the small number of observations. Furthermore, I find strong evidence for the existence of a political business cycle (*Election*).

The costs of the financial sector interventions (*Bailout*) lead to an increase in fiscal measures to mitigate the crisis. This finding suggests that the severity of the financial crisis, or at least the severity of its consequences for public finances, impacted positively on fiscal response strategies. Accordingly, it appears that fiscal stimuli and financial bailouts are not independent policy choices. According to one interviewee, 'for us [the national government] saving the banks was one thing, but then when it came to getting the stimulus plans right, we wanted to show the people on the streets that we cared about them too. If we have money for the banks, we have money for the people' (author interview, May 2011).

Whereas this finding in itself is interesting, it may be considered unsatisfactory insofar as the direct costs stemming from the financial sector interventions can account for only a fraction of the bailout programmes as discussed in chapter four. How do the potentially much bigger liabilities factor into the discretionary fiscal crisis responses? Estimating the same model and including contingent liabilities and liabilities instead of the direct costs as independent variables yields different results.<sup>92</sup> Three points stand out here. First, the impact of liabilities such as loans (which are recorded at the debt level), have virtually the same impact as the direct costs. This is intuitive; such liabilities represent 'real costs' for public finances because they are not outside the general government accounting. Secondly, contingent liabilities have a significant and positive impact on fiscal policy

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<sup>92</sup> As the other independent variables remain unaltered by the 'swap' of variables related to the financial sector interventions, full tables are therefore not presented but are available on request.

outcomes, suggesting that higher contingent liabilities lead to a reduction in stimulus spending. I suspect however that this finding is driven by the exceptional case of Ireland. The Irish government had taken on a staggering level of contingent liabilities (almost 200 per cent of GDP in 2009) and at the same time was faced with pressure to consolidate public finances; it implemented very few stimulus policies. Thirdly, excluding the Irish cases, and thereby reducing the sample size by three observations, leads to the same conclusions as the other two financial bailout variables. These points speak to the fact that a) the costs, hidden or visible, from the financial sector interventions, are linked to the severity of the economic and financial meltdown and as such b) are an indicator of the (perceived) need to stimulate aggregate demand as well as the fiscal costs of the downturn more broadly.

### **The deficit and debt bias pre and per crisis**

Before addressing the key findings in greater detail, I test whether the deficit and debt bias of public finances is larger in times of economic crisis. The structural breaks discussed above prevent me from comparison within a single model. Instead, I run the same specification (subject to the same robustness tests) for the 1999, the year of the introduction of the euro, to 2007 period. Results are presented in Table 5.4. What jumps out immediately is that only the variable pertaining to the political business cycle hypothesis is significant across specifications. Neither the fragmentation of government and the opposition nor the partisanship of the executive is found to determine fiscal policy outcomes between 1999 and 2007.

*Insert Table 5.4 here*

Tornell and Lane (1999) argue that pressures for increased spending may become stronger in economically good times; as resources are more abundant and the benefits from lobbying increase, fiscal policy is likely to become pro-cyclical in good times. Yet in the light of explicit EU-level and domestic calls for stimulus

policies, it seems that the bad economic climate increased the perceived need and justifiable scope for government intervention. The deficit and debt bias of contemporary public finances should be just as strong, if not stronger, in times of economic crisis. Looking at crisis budgeting across the OECD, Schick (2009: 11) concludes that in times of crisis ‘when stimulus is the order of the day, the main issues in dispute are how big the increases should be and who should get them’. With the general modus of public finances ‘switched to stimulus spending’ the benefits for lobbying consequently increased instead of decreased, as Tornell and Lane (1999) assumed. For example the German government hosted an ‘economy summit’ at the end of 2008, with representatives from the executive, science, industry, trade unions, and interest groups to discuss possible options for coping with the economic crisis (FAZ 13.12.2008).

### **The role of automatic stabilisers**

Chapter 4 presented the positive correlation between the size of stimulus packages and the size of automatic stabilisers, a relationship that is now confirmed by means of regression analysis. Instead of implementing a substitution strategy, governments with larger automatic stabilisation were also engaging in more discretionary spending to combat the crisis.<sup>93</sup> This positive relationship may point to the established role of government in countries with large and small systems of automatic stabilisation. Automatic stabilisers are an indicator for the generosity of the welfare state. As such they highlight both the ability of a government to shoulder stabilisation as well as expectations with regards efforts to mitigate the consequences of the economic fallout. This finding is contrary to the recommendation of the European Commission (2009), which argued that the size of the automatic stabilisers

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<sup>93</sup> Following the Commission (2010), I use an expenditure-based measurement of automatic stabilisation. Fuest *et al.* (2010) and Girouard and Andrew (2005) also include revenue-based indicators (such as corporate, personal income and indirect taxes). To check the robustness of my proxy I also ran the same specification with a revenue-based variable. Analogous to the original measure, it takes the change in the output gap multiplied by the revenue-to-GDP ratio (used as a proxy of the semi-elasticities of the budget balance). My inferences were not affected.

is a key factor in explaining differences in fiscal stimulus across countries: Countries with extensive automatic stabilisers, so the argument goes, should rely less on discretionary fiscal policy spending.<sup>94</sup>

### **Timely and temporary**

In recognising the important role of fiscal policy in the absence of national monetary policy instruments, two problems emerge. Firstly, discretionary fiscal policy may work inefficiently by either targeting the wrong groups or by providing too much or too little stimulus. Secondly, the actual implementation of this stimulus, even if correctly identified, takes time. Such implementation lag emerges because different stimulus measures take different amounts of time to take effect in the real economy. This delay was recognised in a joint letter written by the German Chancellor and the French President, which urged Member States to implement their national stimulus packages ‘without protracted processes’ as ‘speed counts’ (Merkel and Sarkozy 2008), and thus effectively advocated unilateral, instead of coordinated, crisis responses for the sake of timeliness.

Through their very nature automatic stabilisers typically provide timely support, as tax receipts are directly linked to the performance of the economy; they do not require the identification of underlying trends to be analysed by policy makers before any action is taken. The size of the stabilisation provided is linked to the magnitude of the recession or overheating of the economy and, crucially in the context of fiscal sustainability, there is no need to take action to reverse the stabilisation provided once the economy returns to a more sustainable path. Schelkle (2011) thus

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<sup>94</sup> The size of automatic stabilisers also played a role for international attempts to coordinate fiscal stimulus plans at the G20 level (Rommerskirchen 2013a). Schelkle (2012a) shows that the fiscal contribution to aggregate demand for EU Member States is not markedly different from that of the US. In fact, the Spanish stimulus by far exceeds the US stimulus if automatic stabilisers are included (see also Fuest *et al.* 2011). Aizenman and Pasricha (2010) even argue that, properly adjusted for the declining fiscal expenditure of the fifty states, the aggregate stimulus in the US was close to zero in 2009 and that the stimulus package has been exaggerated.

characterises automatic stabilisation as a ‘good governance institution’, which corrects the ‘shortcomings’ of representative democracy.

One solution to the expansion versus consolidation bias and the related concerns over the efficiency of fiscal stimulus policies is the usage of automatic reversals of public spending, also known as sunset clauses. EU Member States did apply sunset clauses in various cases, which provided for the automatic cessation of crisis measures upon the date of the agreed 2011 sunset as laid out in the EU’s exit strategy. The notion that a government anticipating a potential loss of power may seek to constrain its rival by committing future resources to current use is well established in the literature (Persson and Svensson 1989; Alesina and Tabellini 1990). Built-in reversals as a means of self-binding are especially helpful against the background of slow economic growth and what is likely to be a slow recovery, when the political economy challenges of reversing temporary measures are likely to be considerable (Roeger and In’t Veld 2009).

Very few policies introduced as a temporary response to the crisis had built-in sunset clauses (DG Ecfm 2009); indeed most Member States implemented stimulus measures that were permanent rather than temporary in nature (*ibid.*). Of all the EU countries, only Greece and Estonia did not enact any permanent spending measures. In Belgium, Italy, Luxembourg, Malta, Austria, Slovenia and Finland, permanent measures outnumbered temporary ones. In light of the predominant non-automaticity of fiscal crisis policies, the reversal of discretionary spending is therefore subject to the political process of budget consolidation.

## The role of political fragmentation

### *Government fragmentation*

The results of the cross-sectional analysis suggest a diminishing effect of government fragmentation; the less fragmented the executive, that is to say the more homogenous it is, the more stimulus policies were implemented. It is worth noting that this effect is not conditional on the strength of government. Interacting the fragmentation index with a dummy indicating minority or majority governments, as well as the margin of majority, the corresponding coefficients remained insignificant in all of the specifications. Furthermore, the inclusion of quadratic and cubic transformations of this variable, as well as the corresponding measurement of opposition fragmentation, was rejected<sup>95</sup>.

There are several factors that might explain this outcome. Firstly, the literature on the deficit and debt bias of contemporaneous public finances emerges from the implicit assumption that this bias is ‘a bad thing’. Volkerink and de Haan (2001: 221) for example introduce their study with the observation that ‘most industrialized countries entered the 1980s with their public finances in disarray. Yet is it possible that in times of crisis the old equation of political power dispersion and high deficits no longer holds? The findings of this chapter suggest that the answer is yes. One-party, majoritarian<sup>96</sup> governments implemented larger stimulus programmes, all other things being equal, than coalition governments. The main reason for this lies in the fact that the mandate for pro-cyclical spending has reached unprecedented levels in recent history. Previous analyses predominantly studied counter- and pro-cyclical fiscal behaviour jointly. This thesis examines the expansion of counter-cyclical fiscal

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<sup>95</sup> Squared and cubic coefficients were not significant in any of the model specifications. A RESET term further confirmed the linear modelling choice.

<sup>96</sup> In the sample at hand, all one-party governments also held the majority of seats.



policies, which although with the benefit of the hindsight may not always be beneficial, is at least easily justifiable.

The inability to consolidate public finances is attributed to inefficient political equilibria in which coalition members are unable to agree on a consolidation package (Alesina and Drazen 1991). The parallel between consolidation and stimulus packages lies not in their popularity,<sup>97</sup> but in the sense that both represent a breakaway from the fiscal policy of normal times. A strong executive, defined as a single party government, is likely to be in a better position to react more swiftly and forcefully. This claim is echoed in veto player theory (Tsebelis 2002), which predicts fewer changes in the budget in countries where the government consists of several parties and the ideological distance between parties is large. What is more, harking back to the previously discussed heightened ‘visibility of crisis responses’, one-party, majoritarian governments have limited opportunities to engage in (predominantly domestic) ‘politics of blame avoidance’ (Weaver 1986); the burden of recovery hence sits with one party.

One caveat however applies: The measurement of fragmentation does not take into account the nuances of ideological fragmentation. Since it is based on the mere numbers of different parties in a given government (coalition), this says nothing about the ideological proximity of these partners. However there is evidence in the literature on fiscal policy outcomes that high party fragmentation can lead to an increase in government spending, regardless of the ideological positions of coalition partners. Using a formal model, Bawn and Rosenbluth (2006) derive the expectation that due to electoral accountability, a larger number of parties in a coalition results in higher deficits. Furthermore, it has been argued that this relationship holds even

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<sup>97</sup> The majority of EU citizens welcomed stimulus packages; even the German electorate received the fiscal package favourably. According to a 2009 survey, only 15 per cent of respondents thought that the second stimulus programme was ‘too high, whereas 38 per cent thought it was ‘just right’ and 34 per cent thought it was too small (survey based on 1,202 respondents over the age of 18, ZDF Politbarometer 2009).

when a smaller number of larger parties represent the same interests, because the supporters for each party will receive more from the benefits than they pay in additional taxes (e.g. Hallerberg and Marier 2004: 573). That being said, it may be interesting for future studies to consider the impact of ideological fragmentation on stimulus policies.

### *Opposition politics*

The positive coefficients of the measurement for opposition fragmentation initially come as a surprise.<sup>98</sup> The results confirm one half of the fragmentation hypothesis: an increase in homogeneity leads to an improvement of the budget balance. Yet overall the effect of opposition fragmentation is always positive. The same common pool argument should apply for the fragmentation of opposition parties in the legislative. They should have similar ‘grazing’ incentives to government actors. Arguably, this positive sign points to the main challenge of opposition parties, which is the need to mark their position as different from that of the government. As the majority of governments in the EU chose at least some form of fiscal stimulus policies, the prevailing opposition position was by default to oppose the stimulus package. This opposition is not necessarily a veto of stimulus spending as such. In late 2008 for example, the German stimulus package was rejected by the Green party, on the grounds that the measures would lead to ‘more cement and not more justice’ (Heine 2009) whereas the Liberal Party (FDP) argued that it would amount to a dubious ‘debt package instead of stimulus package’ (*der Spiegel* 17.1.2009). This example suggests that opposition to budgetary plans is more nuanced and could be the result of different, even opposite, (strategic adoptions of) ideological positions. The German example also illustrates how such opposition could, despite a government majority, lead to a modification in the stimulus package as the fiscal

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<sup>98</sup> Minority governments must bargain with the opposition to pass legislation (Powell 2000). To test whether therefore the role of the opposition is conditional on the minority/majority status of government, I interacted the fragmentation index with a minority dummy. Both variables were positive and insignificant in all specifications.

plans were contested and (re)negotiated in both the upper and lower house which must have approve the budget (*ibid.*).

The significance of opposition fragmentation comes as a surprise and runs counter to existing studies, interviews and other materials. Note however that the coefficient for government fragmentation is always larger than that for opposition fragmentation.<sup>99</sup> Consequently, fragmentation effects of the executive outweigh any fragmentation effects of the opposition. Existing studies suggest that in times of crisis, we may witness a pure executive mode of policy-making and a ‘rally round the flag’ effect which makes it difficult for the opposition to criticise or even oppose government policies, similar to what has been described during foreign policy crises (see ONeal and Bryan 1995). Describing the mechanisms of crisis budgeting, Schick (2009: 10) considers the tendencies of the budgeting process to become more ‘top-down and centralised’. This ‘expedites the process, invests political capital and urgency in mobilising support, and marginalises those who stand in the way’ (*ibid.*). Accordingly, decisions are largely taken in small groups involving the executive, which results in a loss of power of typical veto players located in the legislative.

There is evidence that the Great Recession has seen an increase in executive policy-making and a marginalisation of the legislative (see Lodge and Wegrich 2012). As one national parliamentarian put it in an interview, ‘there was a general feeling that we were treated as “rubber stamp parliament”’ (author interview, June 2011). In Spain, the government marginalised legislative decision-making, issuing crisis measures as executive orders, which prevent any amendments by parliamentarians (Fleischer and Parrado 2012). Parliament could then only approve or disapprove of these ‘royal decree laws’ without any real powers to shape and amend. Similar crisis decrees were passed in Romania and Hungary. In the case of the latter, the newly elected government in April 2010 proposed an extensive package of controversial

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<sup>99</sup> Both coefficients are statistically different from one another. Coefficient signs remain the same if one of the two variables is excluded.

measures submitting over 80 regulations to Parliament without following customary or mandatory consultation procedures (Parrado 2012).

Parliamentarians whose parties were in government were also unlikely to influence fiscal policy outcomes. In most EU countries, notwithstanding the formal powers of the legislature to modify budget bills, the vote on the budget is considered a vote of confidence in the government according to the OECD Budgeting Database. In Finland, for example, the government declared the vote on the stimulus package an issue of confidence: i.e. the government would have resigned if it lost, which led to an ‘unusually high number of absentees’ (author interview, June 2012); out of 95 votes, 38 parliamentarians abstained (Saramo 2012). Similarly in Belgium, out of 129 votes, 49 parliamentarians abstained when the stimulus was approved (Loi de relance économique 2009).

The Netherlands offers a counter-example to the trend of centralised crisis management. Kickert (2012: 440) considers the Dutch government’s response to the economic and financial crisis, finding that the rescue of the banking sector was undertaken by an elite group comprising the finance minister and the chairman of the Dutch National Bank, which took far-reaching decisions without much significant parliamentary input. Conversely the agreements on stimulus policies ‘were taken in an explicitly politicized decision process’ (*ibid.* 441) with political consultation involving the parliamentary parties and the coalition party leaders.

### **The return of intergovernmentalism?**

The overall dominance of executive policy-making in times of crisis was not only a trend in domestic crisis reactions. Similarly at the European level, both interviewees from the European Commission and the European Parliament complained about the ‘return of intergovernmentalism’ (author interview, April 2011) and ‘executive power grab’ (author interview, May 2011) and argued that ‘clearly already in 2008 the

intergovernmental side of EU became increasingly important' (author interview, March 2011). In particular, members of the EP claimed to have felt 'ignored' (author interview, April and May 2011). The European Parliament had no formal say in the adoption of the EERP; MEPs only formally voted on the plan in March 2009, by which point domestic stimulus efforts were well under way. In its 11<sup>th</sup> March resolution, it states that it 'expects from the Commission clear and strong guidance towards an improved coordinated approach amongst all Member States in managing this deep economic crisis' and warns of 'the risk that the solutions implemented become the sum of all the national policies, with potential conflicts and costs, undermining the single market, the economic and monetary union' (EP 2009). Yet by spring 2009 the vast majority of stimulus decisions had already been approved by national parliaments. In some Member States (United Kingdom, the Netherlands, France, Spain and Germany) governments were in fact already preparing a second round of stimulus programmes to follow the adoption of initial packages.

Fabbrini (2012) argues that French and German governments converged towards an intergovernmental interpretation of EU policy coordination. Sarkozy's crisis management was reminiscent of Charles de Gaulle's vision of a Europe of nation states, a process that perceives integration as driven and controlled by the Member States' executives, with no room for the European Parliament (*ibid.*). In a speech in Toulon on 1<sup>st</sup> December 2011 Sarkozy argued that 'the reform of Europe is not a march towards supra-nationality' (cited in Mahony 2011). Instead 'the integration of Europe will go the intergovernmental way because Europe needs to make strategic political choices' (*ibid.*). Along similar lines, Schmidt (2012:4) states that EU policy-makers 'seem to have moved toward assuming that an intergovernmental Europe is the best way to govern'. She illustrates this claim by pointing to Merkel's much noted speech at the College of Europe in Bruges, where she proposed a new 'Union Method' according to which a coordinated European position could be found not by

pursing the old route of the Community Method<sup>100</sup>, but by coordinating between executive leaders (Chang 2013). Intergovernmentalism in EU policy-making had arguably been on the rise even before the economic and financial crisis of 2008/2009 (see also Bickerton *et al.* mimeo). Puetter (2006), for example, sees the Eurogroup as a conscious attempt by finance ministers to escape the bias towards formal bargaining under the Community Method in favour of informal, deliberative working method. The *Economist's* Charlemagne (11.02.2012) locates the resurgence of intergovernmentalism in the wake of the initial failure to win electoral support for the EU constitution in France and the Netherlands, which resulted in 'intergovernmentalism [to emerge as] the new fashion'. Irrespective of the changing currents of intergovernmentalism over the past decade, there is evidence that crises in general favour intergovernmental policy-making at the international level and executive policy-making at the national level (Lodge and Wegrich 2012). I will return to the role of intergovernmental crisis management in the next chapter when considering the Commission's position *vis-à-vis* the EERP and in the conclusion when discussing various reforms linked to fiscal policy coordination.

### **The role of government ideology**

Results in Table 5.2 show that left-leaning governments implemented larger stimulus packages than their right-leaning and centrist counterparts.<sup>101</sup> However, the results, presented in Table A5.3 of the Appendix, show that a specific commitment to Keynesian demand management in the election manifesto leads to a reduction in stimulus efforts. What is more, a related measurement of right-left,<sup>102</sup> based on

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<sup>100</sup> Under the so-called Community Method, the Commission proposes policy and legislation and shares responsibility for policy execution with national authorities. The Council and Parliament have the role to adopt legislative and budgetary acts and the Court of Justice ensures respect for the rule of law. See also Dehousse (2011)

<sup>101</sup> Including the variable 'right' in the model specification with only centrist governments in the base group yields a significant and negative coefficient. The R2 does however not improve and all other results are virtually identical.

<sup>102</sup> Right-left position of party as given in Laver and Budge (1992). This index adds up different scores in the Comparative Manifesto data.

Comparative Manifesto data, is not significant. These findings are in line with numerous empirical studies questioning the old association of government ideology and public deficits prior to the introduction of the euro. A wave of studies first challenged the partisan theory of public spending and presented evidence of substantial partisan dealignment in the 1980s (e.g. Dalton 1984). These views are supported by the evidence on the determinants of public spending during the 1999-2007 period, (see Table 5.4) where the partisan variable is not significant. How then to explain the shift during the Great Recession? One possible explanation points to the changing fiscal predilection of the electorate and policy-makers.

Lipsmeyer (2011) analyses how policy-makers react to economic crises, arguing that the Great Recession has seen a departure from ‘business as usual’ where governments pursue their policy goals in line with their stated ideological outlook. The severe economic downturn constrained politicians in their ability to enact their favoured welfare policies; even fiscally conservative governments may turn to extensive stimulus policies to ‘buffer people from hardship’ (*ibid.* 977). Along similar lines, Schick (2009: 10) argues that the emergency mood of public finances overrides particularistic, partisan interests. Castles (1998) examined changes in expenditure across OECD countries, concluding that in times of economic crisis the party affiliation of policy-makers does not matter for the state of public finances: ‘the impact of partisanship is contingent on high levels of economic growth’ (*ibid.* 32). Based on an analysis of data from 17 OECD nations between 1981 and 1998, he presents evidence of a diminishing partisan impact on social expenditure during downturns – ‘during economic busts all governments spend more on welfare regardless of ideology’ (*ibid.*). Analysing the Nordic EU countries Finland, Denmark, Sweden, and Norway, Lindvall (2012) argues that the quick adoption of fiscal stimulus measures was made possible by a societal consensus on the role of fiscal policy, which meant that policy-makers were not concerned about indirect political effects for their re-election prospects (see also Vis *et al.* 2011). This mattered particularly for the willingness of the centre-right governments in power in most of

the Nordic countries to adopt expansionary fiscal stimulus policies. This description of ‘default stimulus’ in times of economic crisis fits the situation of fiscal policy making in most EU Member States.<sup>103</sup> Turning to liberal Keynesianism as the ‘model response to economic crisis’ (Pontussen and Raess 2012, see also Grabel 2010) was a move that transcended party lines.

Much has been written about EMU’s evolving logic of fiscal appropriateness<sup>104</sup>, which is enshrined in the SGP (e.g. McNamara 1998; Dyson 2000). Yet the Great Recession even triggered a change in the perceptions of what constitutes viable (appropriate) policy options to mitigate the crisis in Member States where policy-makers seemingly embraced strict rules of fiscal restraint. The old alternatives consistent with decades of relative economic stability were no longer considered to be appropriate given the magnitude of economic downturn. This shift in policy options meant that even policy-makers on the right of the political spectrum were willing to abandon the previously defining policies of fiscal conservatism. However the stimulus consensus was not an instantaneous convergence of fiscal policy preferences throughout the EU. This is perhaps best illustrated with the example of Germany, although other countries, notably Finland and Austria, were initially cautious as well (author interviews, April 2011). Dating back to an arguably failed attempt at demand management in the 1970s, the German position on stimulus spending was initially negative. This stance is rooted in the conviction of ‘basically all leading German academic economists’ who stressed that ‘fiscal policy CANNOT work for principal theoretical considerations’ (Dullien 2008). German government officials echoed these views during the negotiations on the EERP. One participant described a heated discussion amongst EU and national officials: ‘we were witnessing the worst economic crisis in the history of the EU, and all we heard from

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<sup>103</sup> Not all Member States implemented stimulus policies, and fiscal responses to the crisis were nuanced depending on a country’s economic and political context. I will return to the question of the size of stimulus measures in chapter 7 when discussing the issue of fiscal space.

<sup>104</sup> The term ‘logic of appropriateness’ dates back to Risse *et al.* (1999), who seek to explain persuasion as normative suasion, especially in shifting the internalisation of a norm from a ‘logic of consequences’ to a ‘logic of appropriateness’ (see also Olson and March 2004).



the German side was that stimulus doesn't work because of non-Keynesian effects'<sup>105</sup> (author interview, April 2011). On 22 December 2008, the then Finance Minister Peer Steinbrück stressed in an opinion piece in the *Wall Street Journal* that 'large-scale stimulus programmes —and tax cuts as well — would not have any effects in real time' (Steinbrück 2008b). Only a few weeks before he had denounced the UK's cut in VAT as 'crass Keynesian[ism]' (*Newsweek* 11.12.2008). The timing of this is remarkable given that first, at the EU level Member States had already agreed to coordinate substantial stimulus programmes and second, the first recovery package had already been approved domestically. Once concrete stimulus measures were already well on their way the economy minister, for instance, called the German crisis response 'a tailored economic growth package, not a classic stimulus program' (*New York Times* 5.10.2008). On first consideration this linguistic hair-splitting seems to be more a matter of political cosmetics than of economic substance. But in the light of coordination problems it is important to remember that it does not only matter politically whether fiscal crisis policies are in line with a policy agreement (such as the EERP), but also whether other EU Member States perceived them to be so. This especially matters in the context of overcoming a collective action problem, where the incentives for defection rise with the perceived likelihood of other countries complying. By arguing not only generally against stimulus measures, but also denying the nature of domestic crisis response, the German government was *de facto* undermining the coordination of national stimulus programmes.

### **Championing stimulus policies within the Commission**

The embracement of Keynesian style demand policies was not only contested in some Member States, but also proved a divisive issue within the European

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<sup>105</sup> The economic assumption behind the opposition to fiscal stimulus is that forward-looking consumers save the proceeds from a debt financed fiscal stimulus in anticipation of the future tax increases. This behaviour then cancels out the impact of the stimulus and creates a non-Keynesian effect.

Commission. Members of DG Ecfín in particular ‘had huge reservations’ (author interview, April 2011, see also Hodson 2012) about the design of the EERP; ‘For years and years we [Ecfín staff] insist on consolidation and sound public finances and then we should come out and proclaim exactly the opposite?’ (author interview, April 2011). Another official pointed out that the EERP ‘contradicted the philosophy of the Commission diametrically’ (author interview, May 2011). Martin Larch, from the DG Ecfín, and his colleagues worry that the ‘forced combination of accepting violations of the Pact on the one hand and insisting on the formal, although more flexible implementation of the EDP, on the other has not strengthened the already battered credibility of the surveillance framework’ (Larch *et al.* 2010: 23). According to one Commission official, advocating fiscal stimulus policies was ‘not something we [the Commission] would do light-heartedly, but in the light of the magnitude of the economic and financial crisis it became increasingly clear that we needed decisive state intervention to break the spiral of economic slowdown and job losses’ (author interview, April 2011). The Commission’s policy turn can be seen as part of a broader picture of global crisis responses; in sharp contrast to the policies of the Great Depression where fiscal policy was not used extensively (Brown 1956), fiscal policy (in the form of discretionary spending in addition to automatic stabilisers) was the main policy instrument of the Great Recession.

In tracing the Commission’s fiscal crisis framework it is helpful to turn to the public statements made by two, in this context key, figures: the Commission President Barroso and the then Commissioner for Economic and Monetary Affairs, Joaquín Almunia. José Manuel Barroso (2008b) was quick to suspend the SGP as early as September 20<sup>th</sup>, arguing that the Commission could not go on with ‘business as usual’ as ‘Europe’s economy needs a boost to recover, to continue to grow and to provide employment’. Speaking at the European Parliament Plenary Debate only four days later, Almunia (2008a) still stressed the conservative prescription that ‘in budgetary policy, [the Member States] must preserve [their] commitment to fiscal discipline and the rules of the Stability and Growth Pact’. Finding an ally in the

ECB, this assessment was echoed by Trichet who stressed that ‘the Pact should be applied fully’ (*Financial Times* 6.11.2008). These evaluations are at odds with the outlook of President Barroso, who, on the occasion of the extraordinary Commission meeting of 29<sup>th</sup> October, again stated that in the application of ‘the Stability and Growth Pact, of course, there must be scope for fiscal and budgetary policy to be anti-cyclical in a downturn, to maintain demand and protect jobs’ (Barroso 2008c).

With the announcement of the EERP, the views that applying the old rules ‘would lead to a vicious recessionary cycle [... as] it would lead to falling purchasing power and falling tax revenues, to rising unemployment and the accompanying human misery, to ever wider budget deficits, ultimately to a risk of social instability’ (Barroso 2008d) prevailed over more cautious voices. Throughout his remaining time at DG Ecfm until 2010, Almunia stressed the need to balance fiscal stimulus and fiscal sustainability on numerous occasions. Nevertheless, he publicly accepted that ‘monetary policy alone cannot provide the full stimulus needed by the European economy.[...] Realising this [...] we proposed an ambitious economic recovery plan that brings together a fiscal stimulus to boost demand in the short term’ (Almunia 2009).

## **Going to China**

One would expect that given equal popular support, there would be no partisan effect on fiscal policy choices in times of crisis in line with previous studies (e.g. Castles 1998; Lipsmeyer 2011). Right-leaning parties emerged as an ‘unlikely actor’ championing the motto of ‘excessive’ spending. Counter-intuitively, these parties are in a comparatively better place to advocate this expansionary crisis policy not *despite* but *because* of the fact that it contradicts its pre-crisis paradigms on fiscal policy making. The likely reason for this apparent incongruity is that the public does not suspect conservative parties of advocating stimulus spending solely because of the

attributed ‘ideological tendencies’; the policy is perceived as being an objectively motivated one. Buttressed by an image of fiscal conservatism, right-leaning governments may be subject to fewer pressures to justify an increase in spending. Whereas stimulus implemented by the left may be seen as exploiting a crisis for their own ideological agenda, the same programme may be considered an economically necessary move if undertaken by a government considered fiscally conservative. The stereotype of a ‘fiscal hawk’ may then help these parties to secure an agreement on exceptional fiscal policies. This phenomenon of unlikely champions of policies that appear to contradict its policy preferences has been called the ‘Nixon-in-China syndrome’ after Cukierman and Tommasi (1998), who argue that right-wing policies are more likely to be implemented by left-wing parties (and vice versa). This effect has been confirmed empirically by various studies on fiscal consolidation (e.g. Zohlnhöfer 2007). For example, Cyran (2011) stresses that the radical reform of the German welfare system (Hartz IV) could ‘only have been implemented by a Red-Green coalition. In his view, ‘if the [centre-right] CDU or the [liberal centre-right] FDP had taken up such initiative, a revolution would have been set loose’ (*ibid.*).

The embrace of stimulus policies by conservative governments is likely to have political repercussions for Europe’s partisan landscape beyond the Great Recession. Judt (2010) appeared puzzled by the fact that ‘in a series of European elections following the financial meltdown, social democratic parties consistently did badly; notwithstanding the collapse of the market, they proved conspicuously unable to rise to the occasion.’ Indeed, in Austria, the Czech Republic, Finland, Germany, the Netherlands, Sweden and the United Kingdom, centre-left parties made considerable electoral losses (Lindvall 2011). What is more in Germany, the Netherlands, Slovakia and the United Kingdom, centre-left parties either lost power or were forced to leave governing coalitions (*ibid.*). The fact that left-leaning governments were not more likely to engage in more stimulus spending than their right-leaning counterparts may help to explain why parties left of the political spectrum were not able to benefit (at least for the moment) from the Great Recession. Indeed, Bartles (2011) analyses 31

parliamentary elections in 26 OECD countries from 2007 through early 2011 and finds some evidence of a boost in incumbent governments' electoral support associated with spending on economic stimulus programmes.

## **Conclusion**

This chapter has investigated the determinants of fiscal response strategies to the economic and financial crisis, analysing time-series cross-sectional data from the 27 EU Member States over a 3-year time period (2008-2010). Post-war economic history provides evidence that fiscal authorities in industrialised countries may be prone to a deficit-bias, which shows up in large and persistent deficits and growing public debts. The empirical analysis has shown that this bias is even stronger during the Great Recession. One result to highlight is that political-economy factors are found to have shaped public finances during the Great Recession. This finding confirms Gourevitch's (1986) dictum that 'policy needs politics'. Faced with a common shock, countries do not merely respond to the economic imperative of crisis management, but identify different solutions to similar problems. The domestic political processes then influenced the specific features of the policy response. A similar conclusion is reached by Cameron (2012) and Armingeon (2012), who both analyse the drivers of stimulus packages across the EU. Cameron (2012) shows that the greatest expansionary effect did not occur in the countries that experienced the greatest contraction of the economy and that there is at best only a very slight relationship between the extent of the economic contraction in 2008-9 and the extent to which the country's budget introduced a fiscal stimulus in those years. Along similar lines, Armingeon (2012) argues that economic variables had limited explanatory power; they constrain governments, 'but in the end fiscal policy is about politics' (*ibid.* 19).

The empirical results of this chapter suggest that the heterogeneous crisis responses should not only be seen as a result of different economic profiles (the severity of the

recession shock), but also as a consequence of different political landscapes, marked by diverging electoral calendars, government formation and ideological position. This heterogeneity has considerable implications for the latency of EU Member States and in turn the coordination of fiscal policy choices. Member States, without election years falling in the 2008-10 period, for example, were more likely to implement smaller stimulus programmes than Member States where policy-makers faced the electorate. Conversely, right-leaning governments were more likely to have designed larger stimulus plans than their left-leaning counterparts. The differences in the political and economic climate throughout the EU, which are shown to determine the fiscal responses to the Great Recession, means that the production function for fiscal policy coordination is heterogeneous across Member States. Collective action theory, as will be discussed in the following two chapters, would therefore see the likelihood of free-riding increasing in groups with ‘stressful heterogeneities’ (Varughese and Ostrom 2001: 762).

## CHAPTER 6: SEPARATE AND SELECTIVE INCENTIVES

### Introduction

The previous chapter analysed the key determinants of fiscal policy choices during the Great Recession and its findings suggest that the deficit and debt biases may be more pronounced in times of crisis. This has implications for group-oriented policy actions in the context of stimulus spending. With the diversity in terms of political landscape and economic profile the group latency of the EU as a whole increases. According to Olson (1965: 51), the solution to successful collective actions for latent groups lies in the provision of separate and selective incentives. As Varughese and Ostrom (2001: 762) put it, heterogeneities ‘do not have a determinant impact on the likelihood or success of collective action’ since groups can overcome ‘stressful heterogeneities by crafting innovative institutional arrangements well-matched to their local circumstances’.

This chapter will scrutinise two types of different incentives that are thought to affect fiscal policy choices; fiscal rules and market discipline. It examines the impact of fiscal rules on stimulus policies, distinguishing between domestic fiscal rules and fiscal policy agreements found in the EERP<sup>106</sup> as well as the SGP at the European level. Most domestic fiscal rules are designed to restrict policy-makers over a long time horizon in order to achieve fiscal sustainability. Their main aim is therefore to mitigate the deficit and debt bias of contemporary public finances. For the coordination of fiscal stimulus policies, exigent domestic fiscal rules may on the one hand prevent stability free-riding, but on the other hand may increase growth free-riding by limiting (or being perceived as doing so) the scope for fiscal expansion in times of economic crisis. Conversely, the EERP explicitly encourages stimulus

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<sup>106</sup> Strictly speaking the EERP does not qualify as fiscal rule. For the sake of simplicity the term is nevertheless used when grouping domestic fiscal rules, the EERP and the SGP together.

spending and may even be seen as a counterweight to the existing budgetary framework under the SGP and at the domestic level. Domestic fiscal rules and the SGP both rely solely on the threat of punishment as incentive. This incentive usually takes the form of reputational costs (e.g. audience costs as described in Lohmann 2003). Market discipline however also provides positive incentives in the form of lower borrowing costs. Furthermore, market discipline provides exogenous incentives, whereas the punishment associated with a breach of fiscal rules has to be agreed within the group.

This chapter proceeds as follows: First the role of domestic budget rules in steering fiscal stimulus programmes is tested. Given numerous crisis-driven reforms, the endogeneity of fiscal rules and its implications for statistical estimations are considered in detail. The third section discusses the role of the EERP and the SGP. Both types of rules are found to have had no impact on fiscal policy outcomes. In the light of this finding, both the Commission's and Member States' motivations concerning the creation of the EERP and the survival of the SGP are explored. The fourth section analyses market discipline during the Great Recession, paying particular attention to the bi-directionality of market reactions and government responsiveness. The penultimate section considers the differences between fiscal rules and market discipline focusing on the second-order free-riding problem.

### **Domestic fiscal rules**

A fiscal rule can be defined as '[a] permanent constraint on fiscal policy, typically defined in terms of an indicator of overall fiscal performance' (Kopits and Symansky 1998: 2). As such it imposes 'a constraint on fiscal policy with a time-bound character' (Danninger 2002: 7) by setting numerical targets for budgetary aggregates. Poterba (1995) considers the study of fiscal policy choices in times of crisis to be particularly interesting. According to him, fiscal crises provide 'a unique opportunity for studying how fiscal institutions and political factors affect fiscal decision-



making' (*ibid.* 1). He reasons that if fiscal rules such as balanced budget amendments constrain the flexibility of political actors, then states with and without these rules should respond differently to fiscal crises.

Analysing the role of fiscal rules, I employ the fiscal rules index developed by the European Commission (for summary statistics see Table 6.1). Commission services have compiled a dataset on domestic fiscal rules in force, based on questionnaires sent to EU Member States. These surveys request information on the description and definition of the fiscal rule, its coverage, its statutory base, monitoring and enforcement mechanisms, as well as experience applying the rule. Based on the Fiscal Rule Strength Index (FRSI)<sup>107</sup> for each rule, the Commission constructed a time-varying fiscal rule index for each Member State by summing up all fiscal rule strength indices in force in the respective Member State weighted by the coverage of general government finances of the respective rule. The assigned weights are mainly determined by the fiscal strength of the rule and its coverage.<sup>108</sup>

*Insert Table 6.1 here*

### **The endogeneity of fiscal rules**

Empirically modelling the impact of fiscal rules on public finances throws up the challenge of endogeneity. The endogeneity of budget institutions is well-established in the literature. Fiscal outcomes and budget institutions may both respond to other unobserved variables such as a country's Stability Culture<sup>109</sup> or voters' preferences in

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<sup>107</sup> The FRSI considers whether fiscal rules are equipped with appropriate characteristics within the institutional framework of budgetary policy. It is based on (i) the statutory base of the rule, (ii) room for setting or revising its objectives, (iii) the body in charge of monitoring respect and enforcement of the rule, (iv) the enforcement mechanisms relating to the rule, and (v) the media visibility of the rule.

<sup>108</sup> Additionally, it will be interesting for future research to investigate the impact of different forms of fiscal governance (Hallerberg *et al.* 2009) on the spending decisions concerning stimulus policies.

<sup>109</sup> See Howarth and Rommelskirchen (2013) for discussion on the meaning, origins and role of Stability Culture in EU fiscal policy coordination.

addition to the political environment. As Poterba (1996) argues, if voters have a preference for conservative fiscal policy they would be in favour of both low deficit and debt levels as well as tight fiscal rules. The omitted variable of voters' preferences may then play a role in explaining fiscal discipline, however it is exceedingly difficult to accurately measure voters' tastes for fiscal outcomes. Following Holtz-Eakin *et al.* (1988) and Poterba (1995) the use of government party affiliation may be considered a satisfactory, albeit crude proxy. Furthermore, various studies (e.g. von Hagen and Harden 1995; Alesina and Perotti 1997) have considered that budgetary institutions can be treated as exogenous variables uncorrelated with social preferences.

A second potential source of endogeneity stems from the likelihood that fiscal policy outcomes impact on fiscal institutions and not the other way round, raising concerns about simultaneity. Political institutions are artefacts, not natural phenomena. Therefore, so goes the argument, they can be modified and reconstructed. Haan *et al.* (1999) present evidence suggesting that in several European countries, budget rules emerge as a result of previous fiscal outcomes. In his study of fiscal adjustment, Lavigne (2011) argues that although the causal link runs primarily from political economy factors to fiscal policy, it may be the case that fiscal policy choices also influence political and institutional variables. The same logic can be applied to the causality of discretionary fiscal policy and the change of fiscal rules. Debrun *et al.* (2008) on the other hand argue that there is no support for the hypothesis that fiscal rules are introduced at times of recession or fiscal stress. Hallerberg *et al.* (2009) emphasise that budgetary institutions are relatively costly to change and are stable over at least the short to medium term, as fiscal performance cannot quickly feed back into altering institutions. Nevertheless, in their analysis on fiscal governance in EU countries from 1985 to 2004, the authors (*ibid.* ch. 5) also show that countries with histories of fiscal crises have adopted more robust fiscal institutions. Hallerberg

*et al. (ibid.)* argue that through fiscal crises, the electorate learn the potentially disastrous consequences of having decentralized fiscal institutions in place.<sup>110</sup>

The notion of institutional inertia seems unconvincing, especially in light of numerous reforms of fiscal rules in the aftermath of the financial crisis. There is at least one example during the Great Recession where fiscal policy choices and institutional reform were interdependent – namely the introduction of a debt brake in Germany.<sup>111</sup> To tame his rebellious SPD coalition partner, Volker Kauder, Chairman of the CDU/CSU parliamentary group, followed the tested logic of package deals and threatened to vote against the second stimulus package if the debt brake was not introduced (*FAZ* 1.02.2009). Conversely, members of parliament (particularly SPD parliamentarians) who were in favour of a second stimulus package made their approval of the debt brake conditional on the passage of new discretionary measures (author interview, March 2011). Not only did negotiations on debt brakes and similar measures feature heavily in the political discourse of European crisis leaders, but there is also evidence that the majority of Member States have, at least on paper, improved their budgetary institutions. According to information provided in the 2009-2010 Stability and Convergence Programme, 21 EU Member States have implemented and/or plan to implement changes in their respective system of fiscal governance (Ayuso-i-Casals 2010). The European Commission's FRSI (European Commission 2012) indicates a jump from an average of .30 in 2009 to .58 in 2010. The phenomenon of fiscal governance reform is not restricted to EU Member States. Schaechter *et al.* (2012) provide an extensive survey of the adoption of new fiscal rules in response to the economic and financial crisis. Whereas in 1990, only five

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<sup>110</sup> Fiscal crises are however not a sufficient condition for institutional reform. Hallerberg (2004), for example, suggests that fiscal problems in Italy in the late 1970s and 1980s did not lead to meaningful reform due to limited competition amongst parties. Molander (2000) stresses that the fiscal crisis in Sweden in the 1990s did not automatically cause the institutional reform, but instead contributed to a general climate for reform.

<sup>111</sup> The resulting cyclically-adjusted debt brake envisages a 0.35 per cent of GDP limit for federal government borrowing in normal times from 2016 onwards with a transition period starting in 2011 and the Länder budgets are to be structurally balanced as of 2020 (Howarth and Rommerskirchen 2013).

countries (Germany, Indonesia, Japan, Luxembourg and the United States) had fiscal rules in place that covered at least the central government level, the number of countries with national and/or supranational fiscal rules surged to 76 by end-March 2012 (see also Schick 2009: 12).

How then to address the issue of endogeneity? There are two dominant strategies to circumvent the problem: taking the lag and instrumenting. Lavigne (2010) transforms the endogenous independent variables (rule of law, democratic accountability and inequality) by taking the average value of the past three years. A second approach would be to instrument the variable, for example with previous levels of its score and the debt level (Hallerberg *et al.* 2004). I instrument fiscal rules with its lagged value and test for weak instruments; the Kleibergen-Paap rk F-statistic indicated that weak instruments need not be considered a problem for all estimations. The Kleibergen-Paap rk LM-statistics for overall identification allows for strong rejection of the null hypothesis that the equation is under-identified. In brief, the results suggest the model used is reliable. I then proceed to test for endogeneity in the instrumented variable, with results suggesting that endogeneity is not a problem in this analysis (see Table A5.2 in the Appendix). I therefore rely on the original, non-instrumented measure of fiscal rules.

### **Fiscal rules during the Great Recession**

The model used to examine the impact of fiscal rules during the Great Recession is as follows:

$$\Delta \text{fiscal outcome} = \alpha + \beta_1 \text{L.GDP}_{i,t} + \beta_2 \text{L.debt}_{i,t} + \beta_3 \text{L.AS}_{i,t} + \beta_4 \text{Election}_{i,t} + \beta_5 \text{Herfgov}_{i,t} + \beta_6 \text{Herfopp}_{i,t} + \beta_7 \text{Left}_{i,t} + \beta_8 \text{Fisrule}_{i,t} + \varepsilon_{i,t}$$

The coefficient for the fiscal rules index (*Fisrule*) is not significant in any of the model specifications, as shown in Table 6.2. This finding echoes that of Poterba

(1995: 2), who argues that ‘while the budgetary institutions and political climate in a state may be determined by the same factors that influence the long-run choice of spending level, these factors may have less impact on the way states respond to fiscal stress’. Including the same variable in the model for the 1999 to 2007 period suggests that fiscal rules curbed fiscal policy outcomes in the EU (see Table A6.2). How then can we explain the insignificance of domestic fiscal rules in times of crisis?

*Insert Table 6.2 here*

One explanation for the insignificant coefficient of the fiscal rules index takes into account the exceptionality provisions/escape clauses of existing fiscal rules.<sup>112</sup> This means that even high scores on the fiscal rules index may be relatively meaningless, as rules do not fully apply in times of severe recession. The exceptionality provisions of fiscal rules are considered in the Commission’s questionnaires, which have ‘exclusions from the coverage of the rule’ as one criterion. Yet the random weighting of the rule does not change if escape is sought, that is to say when the exceptionality clause applies. On the one hand, even the German debt brake, a self-proclaimed stern rule to be emulated across Europe (Merkel 2010), allows for exceptions in the event

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<sup>112</sup> The role of escape clauses in macroeconomic policy is to enable policy-makers to reap the advantages of following a rule on average, while still retaining some flexibility in defining policies in response to exceptional circumstances (Drazen 2000: 127). The inherent trade-off between flexibility and commitment poses the challenge of identifying the optimal level of commitment in a stochastic world. According to Larch *et al.* (2010: 23) not only the credibility but also the sustainability of a rule-based system hinge on the existence of escape clauses that permit policy-makers to react to especially severe circumstances in times when compliance with rules is no longer a feasible option. As Elster (2000: 163) puts it, ‘tight constitutional self-binding may be incompatible with the flexibility of action required in crises’ – that is to say, a rule-based system should account for various eventualities that are outside the forecast for normal economic and/or political conditions. Otherwise, any political agreement will be forced to catch up with realities and its credibility, as well as sustainability, will be undermined by revisions.

of natural catastrophes and emergencies that are beyond the government's control.<sup>113</sup> Likewise, the Swedish debt break is flexible; it allows room for counter-cyclical policy since the government can, if needed, run a structural deficit during a downturn provided it is offset by a correspondingly greater surplus during the next expansion (Fischer 2005). However the absence of exceptionality clauses does not necessarily mean that policy-makers are bound to the (too) restrictive fiscal rules of better times. In the UK, for example, existing *rules* – a golden rule<sup>114</sup> and a debt ceiling (both holding over the economic cycle) – were not equipped with an exceptionality clause similar to the German one. As a result, existing British fiscal rules under the Code for Fiscal Stability have been put on hold during the economic crisis. In its November 2008 Pre-Budget Report the UK government announced a temporary departure from its rules until 2015/16 and the implementation of a new temporary operating rule which requires the government 'to improve the cyclically-adjusted current budget each year, once the economy emerges from the downturn, so it reaches balance and debt is falling as a proportion of GDP once the global shocks have worked their way through the economy in full' (HM Treasury 2008: 4). The suspension of existing rules is reflected in the largest drop in the fiscal rules index since the start of the recording in 1990 for all 27 EU Member States (from a score of 2.06 in 2008 to -1.02 in 2009). The Finnish and Slovak governments announced less drastic suspensions of budget rules during the crisis (European Commission 2011). Schick (2010: 3) identifies a broader trend here, noting that in many OECD countries 'fiscal rules

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<sup>113</sup> The idea of a 'German debt brake' for Europe may be popular amongst politicians in Berlin, yet it bears little resemblance to the actual dynamics of fiscal rules in Europe. To begin with, various countries had already adopted budget balance rules before 2008. In Spain for example, the general government and its sub-sectors were requested to show a balanced budget or a surplus (this rule covers 100 per cent of general government finances – far more than the 53 per cent covered by the German debt brake). Moreover, it was the European Commission that worried that existing fiscal rules were open 'to some accounting creativity' (Public Finance in EMU 2007: 256). In light of Germany's non-compliance with the SGP and insufficient national rules, the Ecofin Council had previously repeatedly suggested the creation of a 'national stability pact' in order to boost compliance with the Maastricht criteria and to make the attainment of the Medium Term Objectives within the SGP framework more credible. See 'Council opinion of 28 February 2000 on the updated stability programme of Germany for the period 1999 to 2003' and 'Council opinion of 27 November 2000 on the updated stability programme of Germany for the period 2000 to 2004'.

<sup>114</sup> Critics argue that the Golden Rule, which Chancellor Gordon Brown set himself in 1997, was only met by 'moving the goalpost', that is adjusting the economic cycle to fit within the Golden Rule's expenditure targets (IFS 2009: 82).

have been vitiated, at least temporarily, by the global economic crisis'. This does not come as a surprise, especially in the context of executive crisis management discussed in the previous chapter.

Strong fiscal councils in charge of surveillance contribute positively to the FRSI, which is then thought to reduce deficits. However in times of crisis, when there is a convincing case to be made for expansive fiscal policy, fiscal watchdogs may advocate less and not more fiscal restraint, especially since they often also monitor stabilisation efforts. Calmfors (2012) analyses the interesting case of the Swedish Fiscal Policy Council which was created in 2007; the watchdog has the authority to offer specific advice, in addition to evaluation of fiscal policies, employment and growth developments and monitoring how well the government explains its policies. In 2008 the Council considered that 'the Government was then so heavily influenced by the doctrine that active use of discretionary fiscal policy as a counter-cyclical tool should normally be avoided that it failed to realise that the extraordinary circumstances motivated another stand' (*ibid.* 15). The Council criticised government policy as harmful, especially given the comparatively strong position of Swedish public finances. Calmfors argues that, analogous to central bank independence in monetary policy, independent fiscal councils, by enhancing the credibility of sound public finances, increase the scope for activist fiscal policy in downturns; because 'the Council is less likely [than the government] to be suspected of having political motives for fiscal stimulus, which could lead to deficit bias, [...] it could be freer to make recommendations on such stimulus in a downturn and this way increase the scope for efficient stabilisation policy' (*ibid.*). Along similar lines, the corollary of effective fiscal rules may be an increase in fiscal space (European Commission 2009). This could then lead governments to have more room for expansion in bad times and, accordingly, to implement larger stimulus packages. As such, this might suggest why strong fiscal rules, as in the case of Sweden, may lead to more and not less fiscal expansion.

The preceding discussion suggests that the impact of fiscal rules on stimulus decisions is likely to be nuanced and contingent on a country's specific economic and political profile as well as the particulars of fiscal rules. Crisis budgeting is, according to Schick (2009: 9) 'inherently improvisational'. This means that '[r]ules and procedures are devised to accommodate the needs of the moment, and frequent adjustments are made along the way. Ad hockery is necessary because established procedures get in the way of dealing with the crisis, and new players are brought into the process (*ibid.*)' It may well be that the FRSI employed in the empirical analysis does not accurately reflect either the 'ad hockery' of crisis budgeting or the variation of existing escape clauses.

### **EU rules: the European Economic Recovery Plan and the Stability and Growth Pact**

The EERP, discussed in the introductory chapter, represents a considerable shift for fiscal policy coordination in the EU. Particularly, this crisis agreement breaks away from former commitments to fiscal constraints and encourages stimulus spending across EU Member States to combat the worst financial crisis since the 1920s. I empirically test the impact of this agreement alongside the SGP by augmenting the sample size and including 5 OECD countries in the main model; Switzerland, Norway, Japan, Canada, Iceland and the United States.<sup>115</sup> This inclusion makes it possible to ask whether countries which signed up to the EERP and are, at least in theory still subject to the SGP, adopted identifiably distinctive response strategies to the financial and economic crisis. Specifically, the variable *EU* takes the value 1 for all EU countries in the 2008 to 2010 period and 0 for the 5 non-EU OECD countries. Controlling for the economic climate and the political landscape, I would expect that EU Member States adopted larger stimulus programmes than their non-EU

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<sup>115</sup> These countries were selected based on their status as developed countries and data availability from AMECO. Related summary statistics can be found in Table A6.1 in the Appendix.



counterparts, being spurred on by the creation of EERP and the flexible implementation of the SGP. Two related caveats apply. The first is that the *EU* variable is a crude, binary measure of any incentives stemming from this vague commitment. It could just as well measure EU membership per se or the underlying attitudes to government intervention, which may be different from Japan or the United States. Put simply, the variable is likely to capture much more than the EERP and the crisis-mode of the SGP. However in the absence of more sophisticated measurements, this empirical strategy is well established in the existing literature on the determinants of fiscal outcomes. The majority of empirical studies on the effect of EMU membership rely on similar dummies to capture the impact of various EU agreements.<sup>116</sup>

A further caveat concerns the direction of causality; did the EERP impact on public finances or did public finances determine the content of the EERP? Did the explicit flexibility of the SGP cause fiscal outcomes, or did the fiscal positions of Member States lead to a system of greater flexibility? The majority of Member States announced their own national stimulus programmes prior to the launch of the EERP. Spain was the first country to implement stimulus policies in line with election promises in the spring of 2008 and announced new stimulus measures on 26 October (*New York Times* 27.10.2008). Germany announced its first stimulus package (*Konjunkturpaket 1*) three days later (*FAZ* 2008). The UK's Chancellor of the Exchequer set out the UK's anti-recession plan on 14 November (*Financial Times* 14.11.2008) and the Italian government unveiled an €80bn fiscal package on 18 November (*New York Times* 19.11.2008). Instead of forging an EU-wide coordinated economic stimulus, governments did not wait for the 'green light from Brussels' (author interview, April 2011) to simultaneously announce independently designed national fiscal policies in the winter of 2008-09. This raised concerns from former Eurogroup chair Jean-Claude Juncker who called for better European

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<sup>116</sup> On the 'Maastricht effect' and the 'SGP effect' see *inter alia* Freitag and Sciarini 2001; Busemeyer 2004; Annett 2006; Hughes Hallett and Lewis 2008.

economic coordination, worrying that ‘Member State after Member State is arranging its own plans and programmes’ (*Euractiv* 10.2.2009). Perhaps the relationship between the EERP and fiscal outcomes should best be modelled as bi-directional. But in light of the large potential coverage of the EERP, multi-causality should be not much of a problem. After all, the dummy also provides a measurement of EU membership per se, which was (as of late 2013) not changed by the scope and design of stimulus programmes.

### **Empirical results**

The inclusion of the five non-EU OECD Member States results in a slight change in model specification. Due to data availability and different accounting standards from different institutions, the costs of the financial sector bailout as well as the size of automatic stabilisation are no longer included. The model used is as follows:

$$\Delta \text{fiscal outcome} = \alpha + \beta_1 L.GDP_{i,t} + \beta_2 L.debt_{i,t} + \beta_3 EU_{i,t} + \beta_4 Election_{i,t} + \beta_5 Herfgov_{i,t} + \beta_6 Herfopp_{i,t} + \beta_7 Left_{i,t} + \varepsilon_{i,t}$$

As can be seen from Table 6.3, the variable *EU* is not significant in any of the model specifications. To nuance the investigation I also included a dummy for eurozone membership first in the sample of EU and second in the sample of EU and non-EU countries. This is thought to capture the fact that the pressures for fiscal policy coordination are potentially greater for eurozone Member States than for eurozone outsiders (see chapter 2). Again the variable is not significant in any of the specifications (see Table A6.3 and A6.4 in the Appendix). These findings suggest that the EU’s fiscal agreements, be it under the EERP or under the SGP, did not influence fiscal outcomes during the Great Recession. Instead, stimulus spending as a response to the economic downturn seems to have been a default option for developed and, to a lesser extent, developing countries (Velde 2011). It would be a mistake to assume that just because Member States predominantly resorted to an increase in public

expenditure to combat recession that these policy choices were driven by EU-level incentives. This echoes the challenges of the claim that the Maastricht treaty brought about a period of fiscal consolidation by Member States eager to comply with the entry criteria for monetary union. Hercovitz and Strawczynski (2005: 822) for example, support Galí and Perotti's view (2003) that government spending adjustment in the 1990s should be 'characterized as an OECD phenomenon rather than as a phenomenon specific to countries participating in the Maastricht Treaty or the Stability and Growth Pact'.

*Insert Table 6.3 here*

As far as the strength of the separate and selective incentives at the EU-level goes, the insignificance of the EERP (EU) coefficient does not come as a surprise. Verdun and Heipertz (2010:189) describe the overall approach to fiscal policy coordination during the Great Recession as 'one of pronounced national action and limited European coordination, the communication of which bordered on the meaningless'. Evaluating the impact of the EERP, virtually all Commission officials interviewed described it as an acknowledgement of Member States' unilateral crisis policies; a 'salmagundi of national plans' (author interview, April 2011) amounting to 'what Member States were comfortable doing anyway' (author interview, May 2011), 'merely stated the existing state of play' (author interview, March 2011) and 'merely rubber-stamped the policy initiatives that Member States had already in their pipelines' (author interview, April 2011). This throws up the questions of why the EERP was launched in the first place and why the SGP was still applied. How can we reconcile the SGP's survival with the creation of the EERP?

### **Reconciling the EERP's creation and the SGP's survival**

Schelkle (2012a: 377) argues that 'the opening the Excessive Deficit Procedure [EDP] became less of a regulatory process than a weak substitute for binding fiscal

policy coordination'. Various interviewees supported this position: 'for the Commission it was important to give at least a resemblance of normality and to go through the motions, no matter whether they would have an impact on public finances or not' (author interview, May 2011). The opening of the EDP is not a sign of the SGP's 'resilience' as Hodson (2010: 232) put it, but its inconsequentiality. During the Great Recession, as deficits were neither small nor temporary, 24 EDPs were opened. In setting and extending the deadline for correcting these excessive deficits, Member States gave themselves considerable room for manoeuvre in the face of 'special circumstances' and 'unexpected adverse economic events' (Article 126.7). Since the initial (re)opening of the procedure, the already delayed deadlines for correcting an excessive deficit have been further set and frequently revised.<sup>117</sup> Prior to 2011 all decisions related to the SGP's preventive and dissuasive arms were subject to unanimous voting. With all but three (Sweden, Estonia, and Luxembourg<sup>118</sup>) EU Member States in excessive deficits during the Great Recession, a scenario where sanctions would bite was deemed 'absurd' (author interview, May 2011): 'dogs do not eat dog' (author interview, May 2011). What is more, the cost of sanctions is higher. Not only are sanctions more counter-productive for a country facing a major economic downturn, the possibility of retaliation also increases these

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<sup>117</sup> For example the initial deadline for the correction of the excessive deficit in Spain was revised from 2012 to 2014. The ultimate impact of the EDP on public finances remains to be seen. One interviewee from within the Commission was however sceptical: 'Nobody in the current climate [referring to the Sovereign Debt Crisis] reads the opinions on the stability programme as we moved from exit strategy to survival strategy' (author interview, April 2011). Amidst the overall 'extremely generous' (author interview, May 2011) application of the EDP, the case of Greece stands out. Here the national government had little success in appeals to exception. After establishing an excessive deficit in April 2009 the Council decided, as of November 2012, to move to the next stage of the EDP procedure, four times giving notice under Article 121 (4) and reinforcing fiscal surveillance under Article 126(9). This represents the first time the two provisions have been applied together. Greece was the only country where the 'exceptionality argument' was not accepted; 'the situation in Greece was a crisis on its own and had very little to do with the economic downturn' (author interview, April 2011). It was therefore argued that in 2009, 'the Greek public finances have worsened much beyond what could have been expected to result from the downturn and the financial-sector support measures' (COU 2010). The application of the dissuasive arm of the SGP points to the intergovernmental nature of the 'appeal to exception', which relies on the evaluation of the justificatory circumstances taking place in the Council. Given the spreading Sovereign Debt Crisis and the mounting evidence of fraudulent statistics, the general reasoning within the Council was 'to come as hard down on the Greek government as possible, without making matters worse' (author interview, August 2011).

<sup>118</sup> Luxembourg however exceeded the 3 per cent threshold. Because the deficit was temporary and stayed close to the reference value no EDP was opened.

costs for a punishing country likely to breach the SGP. Anderson and Putterman (2006) as well as Carpenter (2007) have elicited a demand function for punishment by a systematic variation of the prices of punishment. These studies show that the law of demand holds: the quantity of punishment demanded is lower with a higher price. Following this argument one would expect the likelihood of sanctions under the EDP to decrease with an increase in cost. Furthermore, empirical research also suggests that the deliberative nature of fiscal policy coordination may precipitate a general environment of non-compliance. For instance, de Haan *et al.* (2003) show that the probability of eurozone Member States being sanctioned under the EDP is inversely related to the number of countries that breach the SGP. This could have a herd or contagion effect: ‘it is hard to imagine that Member States on the verge of breaching the deficit criterion sometime in the not so distant future will take a tough stance with regard to those countries that already have an excessive deficit’ (*ibid.* 20). Steclebout-Orseau and Hallerberg (2007) reach a similar conclusion; in their game theoretical analysis of SGP compliance, they argue that if governments know that enough of them will not comply with the Pact and that they can constitute a blocking minority, compliance is unlikely. This means that if a large number of countries run high deficits simultaneously, it also weakens the incentives for other countries to comply with the SGP.

The tensions surrounding the suspension of the EDP in 2003 have shown that it may be politically more harmful to suspend the rules than it is to open an EDP with generous correction targets (Meyer 2004). Opting for an application of the SGP whilst specifically allowing for excessive deficit spending encouraged by the EERP, the Commission improved its relationship with Member States (author interviews, April and May 2011). Larch *et al.* (2010: 21) assume that if ‘the Commission had stubbornly insisted on the strict application of the Pact, including the ban of discretionary fiscal expansions, a severe confrontation with the Member States within the Council would have been very likely’. This echoes Howarth’s (2008: 42) assessment of the 2005 reform which ‘far from undermining the potential for

Commission leadership, may increase it by decreasing the potential for member-government-Commission conflict’.

The 2005 reform, with a more lenient reading of exceptional circumstances, increased the Pact’s flexibility. In so doing, the reform legitimised the weak compliance with the SGP *ex ante* but hardly prepared for the storms ahead. Crucially, the flexibility introduced by the 2005 revision was not the type of flexibility needed to address serious unanticipated events (Larch *et al.* 2010: 5). Even though equipped with an escape clause, the SGP is ‘too cumbersome and retrospective in its procedures to permit an early and aggressive response to a major slump’ (Lane 2003: 568). When the economic crisis spread throughout Europe, the SGP lacked specific provisions for excessive stimulus spending which would lead public finances further away from the criteria of ‘temporariness’ and ‘closeness’. The SGP was not equipped with a crisis-fit *Sollbruchstelle*, that is ‘the built-in capacity to self-correct and break down graciously’ (Lohmann 2003: 104), in exceptional times.

From the very beginning of the Great Recession, it became apparent that the vast majority of Member States considered EU rules to be void in extraordinary times.<sup>119</sup> Given the magnitude of the economic and financial crisis, many Member States ‘did not even see that their stimulus plans were at odds with EU legislation’ (author interview, April 2011).<sup>120</sup> Notably the German Chancellor Angela Merkel and the

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<sup>119</sup> This was not only true for the fiscal rules but also more broadly for State Aid law (see Andreangeli 2012). Mirroring the unilateral design and implementation of the first stimulus spending in autumn 2008, the Commission felt ignored with respect to competition policy. Thus undertaking the quick approval of state aid was not guided by the question of whether or not Member States ‘are throwing money out of their windows or whether a particular measure could have done more effectively, but solely, whether or not this measure would have a distortional effect on the internal market’ (author interview, April 2011). In approving state aid, DG Competition was not concerned with guiding fiscal policy or limiting wasteful public spending (author interview, March 2011). Given that the Commission feared that the Council might decide to put state aid regulation on hold for the duration of the financial crisis, there was a palpable incentive within the Commission to act quickly and present a flexible framework (author interview, March 2011, see also Reuters 4.12.2008). In so doing the Commission was conscious of not putting too many restrictions in the temporary crisis framework, out of fear that ‘Member States would not listen to it in the first place’ (author interview, March 2011).

<sup>120</sup> See also Francois Fillon, then Prime Minister of France, who stated that ‘the stability allows [deficit spending] because it foresees that in exceptional circumstances one can go beyond 3 per cent’ (quoted in Barber 2008b).

French President Nicolas Sarkozy published a joint letter calling for stimulus programmes across the EU, justified by exceptional circumstances as provided for in the SGP (Merkel and Sarkozy 2008). These packages were seen to be ‘the responsibility of the national governments’ (*ibid.*) and should be coordinated in the Council. The role of the Commission in fiscal policy coordination was not mentioned. Given these signals and the unilateral announcements of national stimulus plans, the Commission thought that ‘it was running behind the train’ (author interview, April 2011). With member states deciding unilaterally how to read and apply the Pact in times of exceptional crisis, the Commission saw a need to respond. According to one interviewee, without these national crisis responses ‘we [the Commission] would never have voluntarily recommended any fiscal stimulus [breaching the SGP] at all’ (author interview, March 2013). The EERP was therefore an attempt to ‘get back behind the steering wheel’ (author interview, April 2011); it created an ad-hoc *Sollbruchstelle* to excuse non-compliance.

Hence, the EERP was above all an institutionally strategic policy choice for the Commission. Crucially, the Commission considers the SGP as ‘hard law’, that is, ‘legally binding obligations that are precise’ (Abbott and Snidal 2000). Based on this understanding ‘the problem was not whether countries actually needed stimulus policies, but that according to the [rules] it was simply not allowed. Inasmuch the EERP was an attempt to make the impossible possible’ (author interview, May 2011). The creation of the EERP and the survival of the SGP were deliberate political decisions that were taken, above all else, to justify preceding fiscal policy choices. As such the statistical insignificance of the EERP coefficient should be viewed in these terms.

## **Market discipline**

Given the role of financial market participants in the on-going Sovereign Debt Crisis, the inclusion of market discipline as a constraint on public finances is an obvious

choice. As was briefly discussed in chapter three, the literature on market discipline has considered both market signals as a response to fiscal policy changes, and governments' responsiveness to these signals. Further complicating the relationship between market punishment and government responsiveness is the fact that borrowers may anticipate an increase in borrowing costs and adjusting policies accordingly, see Figure 6.1. This anticipatory mechanism does appear to be at work for example in the UK's austerity policies, despite low borrowing costs (Corsetti 2012).<sup>121</sup> The majority of empirical studies point to a significant effect of market punishment for 'excessive' fiscal policy. In other words, 'excessive' public finances are modelled as a determinant of a country's borrowing conditions (i.e. market's risk pricing). However for this study I consider market discipline as one of Olson's separate and selective incentives. I am therefore not primarily interested in whether or how strongly market participants react to fiscal policy outcomes, but in the response of governments to market punishment.

*Insert Figure 6.1 here*

## **Quantifying market discipline**

*Interest* measures the current debt servicing costs (see Table 6.1 for summary statistics).<sup>122</sup> It is measured as the interest payments as percentage of GDP.

Surprisingly a (variant of the) debt-servicing variable is comparatively infrequently

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<sup>121</sup> This pre-emptive strategy has been notably criticised by Martin Wolf (*Financial Times* 27.5.2010), who argued against 'giving the markets what we think they may want in future – even though they show little sign of insisting on it now'.

<sup>122</sup> The independent variable measuring the 'market punishment effect' (e.g. change in interest rates/debt servicing costs) is included only in its linear form; the square of the same variable is not included. I tested for the inclusion of the quadratic transformations as well as the log transformation of *Interest* to account for the potentially non-linear relationship between interest penalties and fiscal outcomes. Government reaction to higher interest rates is likely to display nonlinearities in the sense that the severity of the punishment may increase borrower's responsiveness. If however a certain threshold is reached at which the solvency is put into question, then it is possible that market punishment may lead to deterioration in the budgetary position. Testing the misspecification of the functional form, the regression equation specification tests (see Ramsey 1969) reject the use of quadratic, cubic and log forms of the variable *Interest*. As such, I model market punishment as a linear relationship.



featured in studies on the determinants of fiscal policy. One exception is Hallerberg *et al.* (2007) who for example argue that the ‘debt servicing costs capture the impact of interest payments as well as political pressures that might emerge from high levels of interest payments on governments’. Yet their empirical analysis on the impact of fiscal governance institutions in 15 EU Member States from 1985–2004 shows that high debt servicing costs lead to higher deficits. Given the substantial size of most government debt burdens, even small variations in bond prices may entail significant real costs for taxpayers, as well as political costs for governments (see Manganelli *et al.* 2009). However, reactions of the financial markets translate only slowly into higher debt servicing costs, as higher interest rates are only to be paid for newly issued debt (Somogyi 2006). Although the residual maturity of debt in the eurozone converged prior to the financial and economic crisis, notably with high-debt countries seizing the opportunity to expand long-term financing at a cheaper cost (Wolswikij and de Haan 2005), there is still (and increasingly so) considerable variation in the average debt maturity structure of the government bond market (Lojsch *et al.* 2011). Government reactions to such market punishment are then likely to be delayed and contingent on the country specific maturity structure of sovereign borrowing as well as broader issues of debt management more broadly. Hence, actual interest payments are the measurement of choice to capture market punishment. The empirical model used is as follows:

$$\Delta \text{fiscal outcome} = \alpha + \beta_1 L.GDP_{i,t} + \beta_2 L.\text{debt}_{i,t} + \beta_3 L.AS_{i,t} + \beta_4 \text{Bailout}_{i,t} + \beta_5 \text{Election}_{i,t} + \beta_6 \text{Herfgov}_{i,t} + \beta_7 \text{Herfopp}_{i,t} + \beta_8 \text{Left}_{i,t} + \beta_9 \text{Interest} + \varepsilon_{i,t}$$

The econometric techniques used and tests carried out are identical to those described in the previous chapter. Adding the interest variable to the main model, I find strong evidence for government responsiveness to market signals (Table 6.4). The results suggest that the responsiveness of governments is not contingent on the degree of discretion of their policy measures. The coefficients for *Interest* in the BB,

PB, PSB are statistically not different from one another. Overall the empirical results suggest that market punishment has constrained national governments in their fiscal response strategies. Notably, this incentive takes the form of rewards for an improvement in the budgetary position and increasing borrowing costs in the case of deterioration in public finances. This means that market punishment is only an incentive against stability free-riding, not growth free-riding.

*Insert Table 6.4 here*

### **Robustness tests**

Again, the market discipline hypothesis has two sides. The first stipulates that financial markets react to fiscal policy outcomes; the second argues that policy-makers react to changes in financial market indicators. This twin logic means that causality is difficult to establish and raises concerns over simultaneity and consequently, the endogeneity of the regressor and heterogeneous dynamic of the error term. The vast majority of studies consider only one side of the MDH and often fail to address the contemporaneous feedback effects between rising interest rates/payments and fiscal policy choices; not considering the feedback effect might lead to misleading conclusions. To rule out the endogeneity of market punishment I instrumented the interest rates variable with its  $t-1$  lagged value. The instrument was found to be correlated with the endogenous regressors and uncorrelated with the structural error term. The null hypothesis of the Durbin-Wu-Hausman test is that the coefficient estimates of the standard regression model and the instrumental variables model are both consistent and do not differ. As shown in Table A5.2 of the Appendix, the null cannot be rejected at standard significance levels, suggesting that endogeneity is not a problem in this case.

## Market discipline and EMU membership

Existing studies suggest that there are important differences in market discipline between non-eurozone and eurozone EU Member States, without necessarily agreeing on their implications. The literature on market discipline in the EMU can be categorised broadly into two groups: upgrading and downgrading. The first group argues that monetary union weakens market discipline, but improves EMU Member States borrowing conditions. The second group assumes that monetary union strengthens market discipline, and leads to a deterioration of EMU Member States' borrowing conditions, downgrading countries that, similar to developing countries, borrow in a 'foreign currency' and therefore suffer from 'original sin' (Eichengreen and Hausmann 2005).

In the upgrading literature, there is evidence that the forces of market discipline were weakened in the wake of monetary union. According to Eichengreen (2009) 'life for small European countries is more comfortable inside the euro area than outside' as being part of a liquid eurozone-wide market in euro-denominated bonds sheltered them from strong market discipline. Arghyrou and Kontonikas (2011) find support for the 'convergence trade' hypothesis for the pre-2007 period, according to which market participants were assuming the best-case scenario of full convergence to German fundamentals, even for countries with a clear deterioration of their macro-fundamentals.<sup>123</sup> Bernoth *et al.* (2004) ascertain that the liquidity risk premium, which reflects the risk that an investor might not be able to liquidate his investment within an expected time period, is reduced with EMU membership (for similar findings see Faini 2005). What is more, prior to the Sovereign Debt Crisis of 2009, eurozone Member States have had a lower default risk premium than they had had before joining EMU. These findings suggest that 'markets may anticipate fiscal

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<sup>123</sup> Convergence of bond yields should not be equated to the absence of market discipline; although market pressure was low prior to 2008, pressure did exist and spread in basis points further reflected different evaluations of domestic fiscal institutions (Hallerberg and Wolff 2008).

support for EMU countries in financial distress’ – despite the No-Bail-Out clause of the Maastricht Treaty (Bernoth *et al.* 2004: 18). Furthermore, Bernoth and Wolff (2008) present evidence that both deficits and creative accounting are penalised less in EMU by financial market participants.

Conversely, the downgrading literature argues that the responsiveness of borrowers increases in a monetary union. First, governments can no longer print their own money as a means of repayment, which renders fiscal consolidation more important as a policy choice to address growing debt burdens. Second, market participants may be more wary of unsustainable fiscal policies because default risks are higher in the absence of debt monetisation (Favero *et al.* 2000; Missale 2001; Antzoulatos and Klinaki 2002). This ‘original sin’ sentiment is echoed by a fund manager asked about the implications of monetary union in Mosley’s (2003) study on the relationship between government and financial markets after EMU: ‘There is no default risk when the government runs its own printing presses, so the risks associated with bonds will change with EMU’ (*ibid.* 193).<sup>124</sup> Given that default is often an abrupt and unpredictable event for investors, markets favour debt monetisation as means to reducing the burden of a high public debt: ‘the high probability of a low impact event (a bit of inflation) is not equivalent to the low probability of a high impact event (default)’ (Gross 2012:42).

To investigate whether eurozone governments are more responsive than non-eurozone governments, I interact the *Interest* variable with a eurozone dummy. Results are presented in Table 6.5. The findings suggest that eurozone governments are more responsive to market signals<sup>125</sup>, confirming the downgrading view of

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<sup>124</sup> Generally applied, this point is nonsensical. Governments around the world have defaulted despite having their own printing presses (Rogoff and Reinhart 2011). Since 1997, 20 sovereign states defaulted: Mongolia, Venezuela, Russia, Ukraine, Pakistan, Ecuador (twice), Turkey, Ivory Coast, Argentina, Moldova, Paraguay, Uruguay, Domenica, Cameroon, Grenada, Dominican Republic, Belize, Seychelles and Jamaica (*Financial Times* 1.10.2011).

<sup>125</sup> In all models presented in Table 6.5 the coefficients capturing market discipline are statistically different from one another.

existing studies. This is in line with Rommerskirchen (2013b), which analyses the dynamics of market discipline for all 27 EU Member States between 1996 and 2012. This study finds evidence in favour of both market reaction to excessive deficits and government responsiveness to market signals. Notably, both mechanisms are found to be stronger for eurozone Member States.

*Insert Table 6.5 here*

### **Overcoming group latency**

Again the main premise of the provision of separate and selective incentives is that they can turn a collective-action situation in which cooperation is irrational into one in which collective action is rational. Investigating three sources of separate and selective incentives, it seems that only market discipline has a statistically significant effect on fiscal policy outcomes and by proxy, on group oriented behaviour. The ‘superiority’ of market discipline to overcome group latency can be found in three features, which are problematised in the literature. First, market discipline in contrast to domestic fiscal rules or EU-level agreements relies both on punishment and rewards. Second, market discipline is not burdened by second-order free-rider problems (see below). Thirdly, and related to the second feature, market discipline does not rely on decentralised incentives and therefore does not face the implementation problems associated with self-regulation.

### **Carrots and sticks**

The asymmetry of EMU’s fiscal rules has been a matter of discussion ever since the 1990s. Larch (2010) points out that there are alarm bells and sanctions if countries breach (or fail to converge to) the deficit and debt reference values, but there are no rewards for doing better than this. This has frequently been referred to the ‘all sticks and no carrots’ problem (Bean 1998). The implicit carrot for well-behaved EU

Member States, that they have room for the automatic stabilisers to operate freely during downturns without being hit by the stick of sanctions, was apparently not ‘tasty’ enough (Buti van den Noord 2003: 740).<sup>126</sup> What is more, ‘the carrot of entry has been eaten while the stick of exclusion has been replaced by the threat of uncertain and delayed sanctions’ (*ibid.* 741)’. This is true for both current eurozone Member States as well as those without ambitions to join the currency union. However the ‘carrot of entry’ may still motivate other Member States seeking to adopt the euro. Estonia is an interesting case in point; during the Great Recession its government implemented radical budget adjustments of approximately 9 per cent of GDP. This considerable consolidation effort was motivated and justified by the Maastricht 3 per cent budget criterion. The adoption of the euro was explicitly recognised as ‘an award or compensation for all the efforts’ (Jorgiste *et al.* 2012: 193). Similarly, Raudla and Kattel (2011) argue that ‘the prospect of joining the euro-zone made the political actors more willing to inflict pain through austerity measures, in the hope that the arrival of the euro would compensate the painful measures in the eyes of the electorate’. To this end, two budget analysts reported on a weekly basis to the senior management of the Ministry of Finance on the current position of state finances vis-à-vis the 3 per cent Maastricht criterion. (Jorgiste *et al.* 2012: 190). The Estonian case suggests that EMU entry as a ‘vincolo esterno’ (Dyson and Featherstone 1997) can still impose an external constraint for economic discipline. It remains to be seen whether the Sovereign Debt Crisis has rendered the carrot less appetising (e.g. Epstein and Johnson 2010).

Using the public good game as a testing ground, numerous studies have analysed the suitability of sanctions or rewards to overcome collective action problems (e.g. Fehr and Gächter 2000; Masclet *et al.* 2003). In general punishments to deviators and rewards to compliers are said to increase levels of cooperation (e.g. Ledyard 1995). There is no clear consensus on whether or not rewards or punishment offer superior

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<sup>126</sup> A similar asymmetry applies to domestic fiscal rules, whose compliance triggers no additional reward other than the benefit of fiscal space.

incentives for collective action. Early analyses tend to argue that in general rewards change people's behaviour more effectively than punishments (e.g. Krasner 1971), however a more recent wave of studies predominantly argues that in direct comparisons, punishment is more successful than rewards in fostering cooperation. Sefton *et al.* (2007) show that rewards seem to be less suitable for sustaining high levels of cooperation, as the decay of contributions over time is faster with the 'reward option' than with the 'punishment option'. In other words, using the carrot is said to be less efficient for enhancing cooperation in a group than the stick. Fehr and Gächter (2000) obtain a similar result, showing that punishment is more effective than reward in mitigating the free-rider problem (see also Sutter *et al.* 2010).

Based on this more recent body of evidence, the fact that fiscal policy coordination amongst EU Member States relies on non-monetary (peer pressure) and in theory monetary (fines under the EDP for eurozone Member States) punishment but not rewards, should *prima facie* not weaken the incentives available.<sup>127</sup> Yet, Andreoni *et al.* (2003) argue that both rewards and punishment should be available as incentives to increase group-oriented behaviour. Rewards and punishments are seen as complementary to one another; based on a series of two person proposer-responder games,<sup>128</sup> they show that when devising incentive systems, the absence of a reward is not equivalent to a punishment. Thus it is important that both tools be present. In a similar vein, Sefton *et al.* (2007) show that allowing for both punishment and reward leads to higher contributions than punishment alone. The carrots and sticks of market discipline are inseparable from one another. They are, in essence, two sides of the

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<sup>127</sup> Both monetary and non-monetary punishments are found to increase levels of cooperation, the former slightly outperforming the later (e.g. Masclet and Penard 2003).

<sup>128</sup> Specifically the authors examine punishments and rewards both separately and jointly. Proposers choose how much to share of a fixed pie. Responders are given one of the following four options: punish and/or reward, reward only, punish only, or neither. By looking at rewards and punishments both separately and jointly the authors are able to discern interaction or complementarity. The findings indicate that rewards alone are relatively ineffective in moving the pie-share offer away from the most selfish one possible. Second, punishments improved cooperation by eliminating extremely selfish offers, pushing proposers in the Stick treatment to modest degrees of cooperation. Thirdly, in the Carrot-Stick treatment the offer was the most generous one possible, often leading to rewards by responders. Even though generous offers were not punished, such offers appeared only when the options of punishments existed.

same coin. These studies then suggest that market discipline, which is thought to reward and punish fiscal policy choices via interest rates adjustments, is a superior incentive.

### **Second-order free-riding**

The choice of a pure punishment strategy for fiscal policy coordination in the EU makes sense if we think of separate and selective incentives as additional public goods that need to be provided by the group. This creates the problem of second-order free-riding. Here, some group members do not contribute to the provision of incentives (reward or punishment), but if the incentive is able to induce group-oriented behaviour, they are able to benefit from the provision by other group members. Instead of solving the initial collective action problem (e.g. why should the individual not cross the picket line?) a new one appears (e.g. why should anyone beat up the persons who cross the picket line?) (Elster 1985: 146). Oliver (1980) first scrutinised how the use of a selective incentive to motivate others to act collectively is itself a form of collective action. The starting point is the idea that selective incentives must affect the decisions of all players in the situation. Positive and negative selective incentives are given to different people with rewards are given to those who cooperate and punishments to those who defect. The cost of providing a given reward is an increasing function of the number that cooperate, but a decreasing function for punishment. As a result, negative incentives are cheaper to use the more successful they are at inducing cooperation. In the ideal scenario, punishment creates a situation where everyone cooperates and this negative incentive does not have to be used at all. Its only cost is that of a threat. 'Thus negative incentives are often less costly than positive ones when unanimous cooperation is sought' (*ibid.* 1368). This is the case for fiscal policy coordination. All Member States are expected to comply with the SGP, and all Member States are expected to stimulate their economies, albeit to different degrees under the EERP. A similar logic holds for domestic fiscal rules, where all sub-sectors of the regional and federal governments are required to



comply. In brief, a pure punishment strategy is more cost-efficient in the context of fiscal policy coordination.

That being said, the problem of second-order free-riding still poses a problem for the implementation of negative incentives. Why should the leader of one country vote in favour of a fine for the leader of a country violating fiscal agreements? Particularly in the context of package deals and issue linkages (Weber and Wiesmeth 1991), where trade-offs of benefits and costs are sought over different issues areas, voting on the EDP became quickly a vote about more than just compliance with the SGP. Voting was regarded as a ‘matter of diplomacy’ (author interview, June 2011). In contrast to EU rules, the incentives offered by market discipline are not subject to second-order free-riding. This is due first to the fact that market discipline is no second-order public good. The main purpose of market discipline is not rewarding and punishing sovereign borrowers. Market discipline is instead a by-product of risk pricing. In other words, what is referred to in this thesis as market punishment is not the result of a normative or pedagogical agenda of market participants, but instead, first and foremost, the result of any portfolio model with standard preferences for risk and return. Put crudely, market discipline is therefore primarily concerned with supply-and-demand, not crime and punishment.<sup>129</sup> It follows that in contrast to punishment and reward options amongst members of a latent group, there are no additional costs for production of market punishment and rewards.

### **The limits of self-regulation**

The second, closely related reason why market discipline does not suffer from second-order free-riding is that it is an external source of punishment and reward. As such it is not provided within the group facing coordination problems. External, also called centralised, institutions are shown to improve cooperation in common-pool

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<sup>129</sup> I owe this point to Waltraud Schelkle.

problems (e.g. Ostrom *et al.* 1992; Fehr and Gächter 2000). In Baland and Platteau's words (1999: 345) external sanction systems are usually necessary 'to make up for several deficiencies of decentralized punishment mechanisms, whether the latter are embodied in strategies of conditional co-operation or involve payoff transfers among agents'. Given the reciprocal nature of sanctions in the Council, it is no surprise that no fines were ever agreed upon. The *de facto* suspension of the EDP since 2003 has cast doubt over the assumption that 'self-governance is possible' in EU fiscal policy coordination (Ostrom *et al.* 1992).<sup>130</sup> The politicised fiscal surveillance amongst EU Member States has been frequently described by observers as 'turkeys deciding on the menu for Christmas' (Schelkle 2009: 835), '[coming] close to asking turkeys to vote for Christmas' (Begg 2003: 3), and 'like asking the turkey what we have for Christmas dinner' (Eijffinger 2004). Game-theoretical accounts of collective action stress that players seek to assess the intention of the other players. Consequentially they are said to be prone to reward players that intend to reward them and they are inclined to punish players that intend to punish them (Gürerk *et al.* 2006). In addition, Nikiforakis (2008) shows by means of a public good experiment that, in the presence of counter-punishment opportunities, co-operators are less willing to punish free riders. It follows that they are also, as in the case of the SGP, likely to refrain from punishing other 'players' who have previously not punished them or are in the future not likely to punish them for transgressing. In the case of market discipline there is no immediate possibility for retaliation, as market participants are not group members. Although governments can restrict and, to a certain extent, shape borrowing conditions (for example via financial repression; Reinhart *et al.* 2011), the relationship between sovereign borrowers and financial markets is not reciprocal.

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<sup>130</sup> Perhaps the most glaring example of the weak post-crisis application of the Pact can be seen in Ecofin's decision in June 2007 to close an EDP against Greece despite 'what transpired to be, widespread inaccuracies in the country's official statistics' (Hodson 2012: 58).

## Conclusion

This chapter has analysed the effectiveness of different incentives to motivate group-oriented behaviour. Based on the empirical findings, domestic fiscal rules did not impact on the fiscal policy responses to the Great Recession. Similarly, E(M)U's fiscal agreements, the proxy for the SGP and the newly created EERP, did not impact on fiscal policy choices. In contrast to these fiscal rules and intergovernmental agreements, the incentives provided by market discipline are found to steer public finances. Importantly, this effect is stronger for eurozone Member States, whose fiscal policy choices in the absence of debt monetization are viewed more critical by financial market participants.

These findings do not come as a surprise. First, the majority of domestic fiscal rules were equipped with exceptionality clauses. Consequently, they did not impose stern constraints on fiscal policy choices in times of crisis. And even where those escape clauses were not in place, policy-makers – in the mode of executive crisis management – loosened the rules to enable them to mitigate the economic fallout. Empirically, this is problematic for the strength of the Commission's FRSI. On the one hand, a lawful evocation of an escape clause did not show up as a change in the fiscal rules index. However on the other, a suspension of existing rules, as in the case of the UK, did lead to a deterioration in the FRSI. The result in terms of fiscal outcomes may nevertheless be similar. Put simply, a given score in the fiscal rules index in good economic times is not automatically equivalent to the same score in bad economic times when exceptionality clauses are evoked. To better investigate the impact of fiscal rules in times of crisis it would be interesting to develop an index that takes into account the evocation and scope of exceptionality clauses.

Secondly, the role of EU rules and agreements in shaping fiscal policy choices has been placed under scrutiny ever since the creation of the SGP; the history of the SGP matters. Accounts of collective action tend to be pessimistic with regards the possibility of group-oriented behaviour in the case of anonymous and infrequent

interactions. The coordination of fiscal stimulus policies should be seen against a backdrop of a patchy first decade for fiscal policy coordination in the EU, which imparted the impression that agreements on fiscal matters were not binding. The choice of ‘right’ fiscal policies remains contested among EU Member States and ultimately they responded to the crisis in a way that ‘suited governments’ (author interview, April 2011), but which had ‘nothing’ (author interview, April 2011) or ‘very little’ (author interview, August 2011) to do with EU agreements. The vague commitments under the EERP and the generous implementation of the EDP further speak to the reluctance of sovereign policy-makers to coordinate fiscal policy in times of crisis. The recovery plan did not establish an ‘agreed rule of the game in the macroeconomic sphere that constrain, or determine, at least some instruments of macroeconomic policy’ which then can ‘be regarded as a form of policy coordination’ (Currie *et al.* 1989: 14). Member states did not ‘pursue different policies than they would have chosen had policy-making been unilateral’ (Webb 1995: 11).

In contrast to budgetary rules and the EERP, market discipline offers both negative and positive incentives, via a change in the borrowing costs. Ideally, sound public finances are rewarded, whilst unsustainable budgetary positions are punished. There is evidence that this diversification of incentives may increase government responsiveness. Perhaps more importantly, market discipline is not subject to the second-order free riding problem and is not a decentralised incentive provided within the collective action group. Markets do not punish governments to prompt budgetary consolidation; market punishment is instead a by-product of risk pricing.

Market participants’ punishment points to an alternative explanation for the creation of the EERP. Mosley (2000) presents the use of the Maastricht convergence criteria as a case where governments influenced financial market behaviour.<sup>131</sup> She (*ibid.*

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<sup>131</sup>A similar point is made in Schuknecht (2004: 19).

752) argues that by setting the deficit ceiling of 3 per cent, policy-makers established the very criteria by which they were later judged:

Prior to the mid-1990s, market participants took a “less is better” view of government budget deficits: four per cent was better than 5 per cent, and 5 per cent was better than 6 per cent. They did not expect governments to meet a specific deficit target or to do so by a particular date. The Maastricht recommendations served as a specification – and an ‘above or below 3 per cent’ dichotomization—of an otherwise fuzzy concept.

So far the EERP has only been considered as an internal signalling device; important to convey to other Member States the need for stimulus policies and for creating a system of fiscal rules that was compatible with the economic fallout of the Great Recession. Yet, is it possible that the EERP was in part created to provide a ‘judging yardstick’ similar to that of the Maastricht criteria? Whereas numerous interviews pointed to the role of financial market participants in curbing government spending during the financial and economic crisis, only one interviewee linked market punishment to the creation of the EERP: ‘in times of crisis when there is big uncertainty on parts of the market and lack of information, having something like the EERP [...] played a positive role’ (author interview, March 2011). An interesting direction for future research might be to investigate the relationship between EMU’s old and new fiscal rules and market discipline by paying particular attention to the various numerical thresholds set in those rules.

## CHAPTER 7: FREE-RIDING – STABILITY AND GROWTH

### Introduction

The preceding chapters have described how EU Member States' stimulus packages varied considerably, depending not only on a country's economic situation, but also on a host of other 'political' factors. These findings suggest that the coordination of fiscal response strategies to the crisis may be hampered by a high degree of group latency. Latent groups face difficulties in managing collective action, which subsequently gives rise to concerns about free riding. In economic terms, free-riding refers to a collectively produced good being used by a group member without contributing his share in producing it. This becomes a problem if free-riding has a negative impact on the production of this public good. In the context of fiscal policy coordination, free-riding behaviour can be divided into stability free-riding and growth free-riding. The previous chapter suggests that stability free-riding was punished by the existence of separate and selective incentives in the form of market discipline. However there is no evidence for the working of other incentives to limit growth free-riding. Whereas markets punished Member States for deficit spending by imposing higher debt servicing costs, neither fiscal rules, be they EU or domestic in nature, nor market participants, disciplined policy-makers that failed to stimulate the national economy.

This bias is interesting given that prior to 2010 the discourse on free-riding (or beggar-they-neighbour strategies) focused predominantly on growth free-riding. For example, Wyplosz (2009) warns that '[given] the high degree of trade integration within the EU, the danger of free-riding is acute'. Is this concern justified? At first glance it seems that the answer is yes. According to the ECB measurement of stimulus spending in 11 EU Member States did not meet the EERP call to implement fiscal packages of 1.2 per cent of GDP. According to my own comparison of data

available (chapter two), I suggest that the figure should realistically read 9 Member States – still a third of the total. Given that Member States agreed on the 1.2 per cent only *after* most had already designed their national stimulus plans, this high figure is noteworthy.

To put this figure into context, this penultimate chapter will analyse the evidence for and against free-riding behaviour relying on qualitative, quantitative and qualitative comparative methods. The next section will briefly present the political climate of (alleged) fiscal free-riding during the Great Recession, reviewing some of the main accusations and defences. In the second section, I will test two of the main characteristics of free-riding states as presented in the literature (see chapter three): trade openness and economic/political power. Given the small sample size of this study I will do so by relying on fuzzy Qualitative Comparative Analysis (fQCA). The results based on fuzzy set analysis suggest that larger and more open economies had more substantial stimulus programmes, despite their greater ability to free-ride. The third part of this chapter considers fiscal response strategies in relation to a country's fiscal space. To do so, the concept of fiscal space is first introduced before an original composite indicator based on the EU's Excessive Imbalances Procedure (EIP) is proposed. Results show that by and large Member States stimulated their economies in line with their fiscal room for manoeuvre, as laid out in the EERP. These findings are contrasted with the political discourse of late 2008 and 2009 when accusations of (particularly German) growth free-riding were wide-spread.

### **Fiscal free-riding**

The EERP (2008) stipulates that stimulus policies had to be targeted towards the source of economic difficulties with measures that supported businesses, labour markets, investment activities, and households' purchasing power (including vulnerable groups). For national policy-makers the spending target clearly had one additional dimension that is, naturally, not mentioned in the EERP; their electorate.

The political discourse on discretionary spending does not even attempt to conceal potential conflicts of the clear national stimulus targets with the principles of the internal market and more elusive notions of European solidarity, which are evoked in the EERP. During the parliamentary debate on the 2009 stimulus package in Austria, for instance, the Socialist (SPÖ) parliamentarian Gerald Klug (2008), warned ‘in order that we do not repeat mistakes of the past, the stimulus package should exclusively focus on measures that work domestically’. Similar concerns could be heard from the erstwhile CDU shooting star Karl-Theodor zu Guttenberg who demanded that ‘our stimulus package should secure jobs in Germany and not jobs in the Far East’ (Reuters 26.01.2009). This nationalistic nature (e.g. welfare protectionism, Morris 1997) is inherent in public spending regardless of the underlying economic conditions. The aim of fiscal policy is to promote the welfare of those contributing to it, and in the absence of a ‘European demos’ (Marquand 2011, see also Cram 2012) or a ‘EU taxman’ this erects easily identifiable goalposts for public spending. In the context of the crisis, with the state in charge of ‘a major injection of purchasing power into the economy’ (EERP 2008) – or as one interviewee put it prompting the ‘renaissance of industrial policy’ (author interview, May 2011) – the discriminatory potential of public spending becomes more apparent. The latter point calls to mind Gourevitch’s ‘visibility of hard times’ (see Chapter 1).

This was especially the case with respect to large-scale subsidies to the automobile industry. One of the most blatant cases of nationalist intervention could be found in the plan of then French President Sarkozy to support the French car manufacturer Renault under the condition that it repatriated production from Slovenia in early 2009. Unimpressed with criticism, Sarkozy announced that if the French government gave ‘financial aid to the automotive industry we [the government] do not want them to set up a factory in the Czech Republic again’ (Rippert 2009). He furthermore urged the carmakers to support French industries involved in supplying parts and services to French automobile manufacturers (*Financial Times* 4.02.2009). Along similar lines the German government’s rescue package for Opel raised concerns



about possibly discriminatory protection of jobs in German plants. The then acting EU Council president, Czech Prime Minister Mirek Topolánek, warned of a ‘protectionist race’ in Europe, whilst the then Swedish Prime Minister, Fredrik Reinfeldt, whose country assumed the rotating EU presidency after the Czech Republic, said that he was ‘very worried at the growing tide of protectionist economic measures in Europe’ (*euractiv* 10.02.2009).

The majority of stimulus policies can hardly be considered an outright violation of the principles of the common market. Protectionism and nationalism often overlap. The surge in soft protectionism via investment policy measures aimed at keeping demand and capital at home went largely unsanctioned under the crisis framework for competition policy. It is important to point out that in the EU as well as in the global economy, the financial crisis has not resulted in a widespread increase in protectionism via tariff policies, – although evidence with regards the magnitude of the rise in protectionism during the Great Recession is patchy (e.g. Baldwin 2009; Bown and Crowley 2012).

It is to be expected that stimulus programmes funded by national means would benefit those who contributed to them in the first place. However the unhidden call for explicitly nationalistic spending programmes is, albeit not strictly against the letter of the EERP, still in stark contrast with the spirit of the plan whose fundamental principle was agreed to be ‘solidarity’. This leads to the question of whether there is much empirical evidence for free-riding. The rest of this chapter seeks to scrutinise the evidence in favour and against the existence of fiscal free-riding during the Great Recession.

The question of free-riding can be analysed by methods similar to those employed in the proceeding chapters, that is by relying on regression analysis techniques. To further test for free-riding behaviour I add three “free-riding variables” (population, trade openness, and economic power) to the main model of the previous chapters. Arguably, if I were to find that, for example, export countries implemented less

discretionary fiscal policies, this would be evidence for the charge that those countries have a greater incentive (i.e. capability) to engage in fiscal free-riding. I find that none of the variables has a significant impact on a country's fiscal response strategies to the Great Recession. An arguably better way to test for free-riding behaviour is to consider compliance with the EERP. Crucially, the EERP sets an absolute, cumulative reference value for the fiscal programmes and not an annual value (as for example the SGP). Because of this, the number of observations available is limited to 27. With so few observations it is not feasible to use appropriate techniques, such as a probit model. What is more, it would be difficult to attribute causal factors to the accumulative outcome. Take for example the variable for the partisan orientation of government. In the case of government change it would be difficult to clearly assign a share of responsibility in the given outcome. A solution for small-N research designs that is increasingly applied throughout the social sciences is the QCA approach (e.g. Schneider and Wagemann 2008; Emmenegger 2011). Ragin (1987) developed QCA initially in order to formalize comparative case study research with small- and moderate-N datasets. This approach is not only advantageous in the light of small numbers of observations, but also given the causal complexity which calls for the necessary modelling of interaction effects and the related loss of degrees of freedom (Ragin 2000).

### **The logic of QCA**

QCA is distinct from other case-oriented methods due to its use of Boolean algebra and set-theoretical insights to operationalise comparison and detect causal

complexity (Berg-Schlosser *et al.* 2009).<sup>132</sup> While it only allows binary variables, its fuzzy-set variant (fQCA) makes it possible to examine continuous and interval-scale variables. The use of fQCA calibrates the causal conditions into sets, which allow for partial membership in a set. Specifically, the membership of each case in a set of conditions may vary between full membership (value 1) and non-membership (value 0) in a set. The value 0.5 describes the crossover point indicating the border between cases that could be ‘in’ or ‘out’ of a set, whereas 0 is a full ‘out’ and 1 represents a full ‘in’. Given that many of the variables of interest are more complex than binary coding would account for, the fQCA approach is an obvious choice. Using a fQCA based research process which is able to detect empirical patterns in the data at hand, I seek to scrutinise fiscal free-riding.

### Variable description

As discussed in Chapter 3, I pursue two related methods to measure compliance with the EERP. The first yields a simple dummy, which takes the value one if the total stimulus package (2009-2010) is estimated as 1.2 per cent of GDP or larger, as the threshold of the EERP states, and zero otherwise. The second accounts for the relative compliance with the EERP and measures the total size of the stimulus package (calculated by the European Commission 2010). The outcome variables used in the presentation of the main results are based on the EC’s estimations. Results for a crisp (binary) outcome variable are virtually the same. As a robustness check, I also ran the QCA using the ECB’s stimulus measurement. All results hold.

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<sup>132</sup> Boolean algebra can formalise the maximum number of systematic comparisons that can be made in terms of the presence or absence of attributes of interest, across the cases under analysis. Rather than estimate the net effects of single variables, QCA employs Boolean logic to examine the relationship between an outcome and all binary combinations of multiple predictors. Its underlying understanding of causation is that of multiple conjunctive causation which relies on a configurational approach to causation. It identifies the different conjunctions of *conditions* or ‘causal paths’, leading to a certain *outcome*. In so doing, it allows for the identification of multiple conjunctive causation and the distinction between sufficient or necessary as causally relevant (Schneider and Wagemann 2008). More specifically, QCA differentiates between causal conditions being necessary but not sufficient, sufficient but not necessary, or necessary and sufficient. The co-existence of various combinations of causal paths that lead to an outcome has been referred to as equifinality of outcomes (Ragin, 2000).

The preceding chapters have argued that the preferred measurement for discretionary fiscal policy is the cyclically adjusted budget balance. This chapter, although still corroborating findings with reference to this indicator, focuses on the stimulus data as presented by the European Commission. This is reasonable since I am interested in the total size of the stimulus package. The addition of differences in fiscal outcomes (e.g. the change of the primary budget balance) used in the two previous chapters would not yield reliable results. Furthermore, collective action theory stipulates that information about other group members' intentions is crucial in the provision of a public good (Olson 1965). The communication of stimulus programmes on a policy-maker and a public (newspaper etc.) level was dominated by the stimulus figures identical, or at least readily comparable, to those published by the European Commission, other international organisations and think tanks (such as the IMF and the OECD). Focusing on the realities and accusations of free-riding, it is advantageous to work with the same data that Member States used in their EU level meetings (author interview, May 2011).

Based on the literature review in chapter three, the two conditions thought to influence Member States' free-riding behaviour and subsequently compliance with the EERP are trade openness and political power. In addition, I control for economic distress. To measure the trade position I take the average trade position (value of imports + value of exports) as a percentage of GDP for 2008-2010. Other variables were considered as well (per cent of world export, per cent of intra-EU export) yielding virtually identical results. The political clout of a Member State is measured by its share of EU GDP. Gross domestic product as a proxy for economic and political power is frequently used in the IPE literature on international policy cooperation (e.g. Martin 1992). Alternatively, I also tested the size of the population as an indicator for economic/political power, and obtained very similar results. The third measurement indicates economic distress (taking the value 1 for these

countries). It is a (albeit crude) way of indicating the health of the economy and by implication, the possibility that stimulus spending occurs.

The first group of countries that are qualified to be under economic distress are under IMF conditionality (Hungary, Romania, Latvia) and the second group belongs to the now infamously dubbed ‘PIIGS’ (Portugal, Ireland, Italy, Greece and Spain).

Although the difficulties faced by these countries are not identical, they are compatible in that they clearly experienced severe economic distress. Table 7.1 displays the fuzzy set scores for the outcome and the three conditions, as well as the best fit for each country case.<sup>133</sup> Results are presented using letters as abbreviations for the conditions and the outcome. C represents compliance with the EERP/the size of the total stimulus package, T trade openness, P political power, and D economic distress. Capital letters indicate the presence of a condition, while small letters indicate the absence of a condition – that is, T indicates a high level of trade openness, and t indicates a low level of trade openness.<sup>134</sup>

*Insert Table 7.1 here*

### **Compliance with the EERP**

To test for free-riding behaviour, I perform a test of each configuration’s y-consistency versus its n-consistency and a test between each set’s y-consistency and

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<sup>133</sup> The transformation of the variables into a fuzzy-value scale was undertaken by creating rank orders of the variable and then standardising this ranking to range from 0 to 1. For a comprehensive, largely nontechnical discussion of the acquisition of membership values in fuzzy set analyses, see Verkuilen (2005). The equation for this standardisation is  $(\text{rankedvar} - \min(\text{rankedvar})) / (\max(\text{rankedvar}) - \min(\text{rankedvar}))$ . An exception are the dummy variables for compliance and the existence of economic distress, they are treated as crisp sets.

<sup>134</sup> Results are evaluated using both graphical representations as well as descriptive measures such as consistency and scores. Consistency assesses the degree to which a subset relation has been approximated, while coverage assesses the empirical relevance of a consistent subset (Ragin 2006: 291). It is important to note that coverage is only interpreted for consistent results. Coverage for inconsistent results is not a meaningful indicator (Schneider and Wagemann 2008: 209). Consistency and coverage are calculated using the ‘fuzzy’ command in stata (Longest and Vaisey 2007), an add-on command that is capable of creating, testing, and performing logical reductions on both fuzzy and dichotomous (crisp) set-theoretic data.

the consistency of all other configurations. I look for the configurations with y-consistencies that are significantly greater than .7 (a conventional threshold, Wagemann and Schneider 2008), as well as significantly greater than their n-consistencies. TPd is the most highly consistent configuration for compliance with the EERP (coverage=.502, consistency=.940). Figure 7.1 presents the result graphically. Note that for a condition or a combination of conditions to be sufficient, all cases should be located around or above the bisecting line/ the diagonal (Ragin 2000: 236). While the consistency of the sufficient condition (TPd) is very high, the coverage is less strong.<sup>135</sup> This is visualised in Figure 7.1 by the proximity of country cases to the diagonal vs. the Y-axis. The closer a country case is to the diagonal, the higher the degree of coverage. Overall, the graphical representation of the fQCA analysis does not support the finding that Member States with open economics and more economic/political power experienced less economic distress or implemented larger stimulus packages (i.e. had better compliance scores). This is in contrast to the implicit or explicit portrait of big, powerful countries as being prone to free-riding.

*Insert Figure 7.1 here*

Visualising this relationship, the scatter plot in Figure 7.2 plots ordered pairs in a coordinate plane to show the statistically significant correlation between the trade openness (TO) and the total stimulus package (FS). At first glance it appears that the strong results might be driven by the inclusion of Luxembourg. However, when this country is excluded the results still hold ( $\rho = .46$ , statistically significant at the 1 per cent level). In addition, I transformed the four main variables in question (FS, TO, POP, ECO) into ranks to see whether the same findings also hold for Spearman's rank correlation coefficients; results are virtually identical.

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<sup>135</sup> Again, consistency trumps coverage. What is more, it is very rare for graphical representations of fQCA analysis to display a 'perfect fit' (with all observations being close to the diagonal), see Ragin 2000; Schneider and Grofman 2006.

*Insert Figure 7.2 here*

Few studies have empirically analysed the problem of fiscal free-riding during the Great Recession. Fuest *et al.* (2010) report a negative correlation (-.4) between the average annual discretionary fiscal measure and their indicator for openness. Yet there is a limited extent to which these findings are comparable. First, the authors use the average ratio of exports to GDP for the 2000 to 2004 period, whereas I construct a measure for the time span of the financial and economic crisis that is congruent with the period of the implemented stimulus packages. Their choice of timeframe is not justified in the text. Secondly, the motivation for the selection of countries is not clear; Fuest *et al.* (2010) analyse 18 EU countries, plus the USA. The inclusion of the USA and the exclusion of 7 EU countries are likely to impact upon results. Thirdly the source for the estimation of the size of stimulus packages differs. Indeed it is not entirely clear what their source is. In the text the authors state that they use the estimations of an IMF staff note, yet said note lists only the stimulus packages of the G20 countries.

A second analysis into the relationship between openness and fiscal response strategies is offered by Aizenman and Jinjark (2010). The authors perform regression analyses looking at the variation in the fiscal stimuli during 2009-2010 in 112 countries (including 25 EU Member States).<sup>136</sup> Specifically, they find higher trade openness (measured by the 2000-2006 average trade to GDP ratio) to be associated with a lower fiscal stimulus. Unfortunately, the authors do not run separate regressions for country groups (i.e. the EU), and given the inclusion of 87 other countries, results are not comparable.

Which countries did not comply with the EERP's call to stimulus? Identifying the fiscal 'laggards' is an obvious step towards identifying the reasons for non-compliance and further shedding light onto the accusations of free-riding behaviour.

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<sup>136</sup> Using simple OLS, tobit, and seemingly unrelated regressions (SUR) estimation.

Based on the comparison of official documents in chapter 4, it seems that the 9 non-compliers with the EERP's 1.2 threshold are: Greece, Romania, Slovakia, Lithuania, Portugal, Italy, France, Ireland and Belgium. The results of the fQCA have already suggested that there is a positive relation between the size of stimulus packages and the absence of economic distress. The countries in the group of non-compliers, with the notable exception of France and Belgium, do all also belong in the group of 'crisis countries', which face exceptional economic distress in a much greater magnitude than the other EU Member States. In line with the idea of 'stability free riding', is it therefore not in the interest of the Union as a whole that these countries should implement substantial stimulus packages? The EERP (2008: 7) states this explicitly:

'To maximise its impact, the budgetary stimulus should take account of the starting positions of each Member State. It is clear that not all Member States are in the same position. Those that took advantage of the good times to achieve more sustainable public finance positions and improve their competitive positions have more room for manoeuvre now.'

The stimulus package should be consistent with a country's fiscal space so as not to threaten the sustainability of public finances, which could have negative spillovers for other Member States as well, especially amongst eurozone countries. In order to better distinguish between stability and growth free-riding, the next section will investigate whether Member States' fiscal response strategies matched their room for fiscal manoeuvre.

### **Fiscal space**

Fiscal space can be defined as 'the capacity of a government to provide financial resources for a desired purpose, subject to the constraint that the fiscal position is sustainable, both over the medium and long-term' (Heller 2005)<sup>137</sup>. Heller's definition gained influence among IMF officials and was originally predominantly applied to developing countries. In the EU, the term 'fiscal space' came to replace

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<sup>137</sup> Schick (2009) suggests a different definition for developing countries according to which fiscal space 'is an estimate of the growth-enhancing investment in physical and human capital that a government can finance with borrowed funds without prejudicing the long-run sustainability of its fiscal position'.



the previously preferred ‘room for manoeuvre’ in 2009 (author interview, March 2011). The discussion within the G-20 and the strong presence of the IMF during the Great Recession made the term ‘fiscal space’ respectable and stripped it from its association with developing or emerging market economies. Whilst the EERP mentions the ‘fiscal room for manoeuvre’, a year later DG Ecfín’s Public Finances in EMU (European Commission 2009: 192) called on ‘countries with limited fiscal space [...] to engage in particularly cautious fiscal policies’. The logic of fiscal space not only had implications for the extent of economic stimulus spending but also for its timing. Focusing on fiscal exit strategies, Marco Buti (2009), Director-General for Economic and Financial Affairs at the European Commission since December 2008, considered that ‘while accelerated fiscal consolidation is the immediate priority for the countries with no or little fiscal space, others with better fiscal space can maintain less restrictive stances in the short term, for the sake of growth and jobs in Europe’.

From a technical perspective, Heller (2005) argues that there are no readily available comprehensive indicators that can be used to measure the availability of fiscal space. In an IMF Staff Position Note, Ostry *et al.* (2010: 4) reach a similar conclusion, namely that in the absence of a clear operational definition of the concept, ‘the talk about fiscal space [...] has so far been rather fuzzy.’ The vagueness of the term fiscal space did raise concerns. The ECB was notably sceptical of the term and feared that in the absence of clear targets and thresholds, countries would interpret the meaning according to their own preferences.<sup>138</sup> The term ‘room for manoeuvre’ is *prima facie* no less vague. But during the first decade of EMU, Member States reached a common reading of the semiotics of this term, namely fiscal policies in line with the SGP. In discussions on public finances it became clear that Member States had ‘quite different’ understandings of their own fiscal space (author interview, March 2011).

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<sup>138</sup> Based on a systematic review of archival material from the ECB, it appears that the ECB did not use the term fiscal space at all prior to 2008. After that the term is used sparingly, mostly in reference to existing literature employing the term and mostly with quotation marks (even when no source of quotation is given). The ECB’s preferred term remained fiscal sustainability.

As one interviewee from the Commission put it; ‘for Finns, fiscal space is there if you can meet all your fiscal obligations for the next 50 years, for some Southern countries, fiscal space is there if you need to spend more’ (author interview, April 2011). Arguably the meaning of fiscal space was further obscured by the ‘bizarre situation, where a country entering the EDP had also a level of deficit spending that still left fiscal space’ (*ibid.*).

Among the most prominent proxies for fiscal space is the ratio of public debt to GDP.<sup>139</sup> It is much less problematic for countries with a balanced budget and low debts to stimulate the economy by increasing demand through increased spending than it is for countries with high debts and deficits. It is argued that in countries with high public sector debt to GDP ratios, lack of fiscal space not only restricts the government's ability to implement discretionary fiscal policies, but also weakens the effectiveness of fiscal stimulus spending (Baldacci et al 2009). Accordingly there should be a negative relationship between the debt burden and the stimulus measures adopted. Aizenmann and Jinjark (2010) construct a variable for the ‘*de facto* fiscal space’ of a country, measured as the inverse of the tax-years it would take to repay the public debt. Alternative methods construct a sustainability indicator comparing the current and future debt levels to identify the fiscal gap (e.g. Buiter 1985; Auerbach and Gale 2011). Problematically, these indicators are based on long-term projections, which are necessarily subject to wide margins of error (Balassone and Franco 2000). An indicator that is based on present and past economic performance has therefore the advantage of being not only more reliable but also to offer greater signalling power for policy-makers. This higher visibility is an important asset in the intergovernmental challenge of EU-level policy cooperation.

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<sup>139</sup> For a discussion of this indicator see Escolano (2010).

## Operationalising fiscal space

Given that the fiscal space of a Member State is an important determinant of their exposure to risk pricing and therefore for ability to pursue fiscal stimulus, it is important to consider a measurement of fiscal space when analysing fiscal policy coordination during the Great Recession. In its annual publication on public finances in EMU, the European Commission presents a fiscal space indicator comprised of five variables 1) the initial public debt, 2) the contingent liabilities vis-à-vis the financial sector, 3) the expected revenue shortfalls stemming from the unwinding of the real estate and construction boom, 4) the current account position and 5) the share of discretionary expenditure in the government budget. Accordingly a large government debt, high contingent liabilities, potentially high tax revenue shortfalls and a large share of non-discretionary expenses are expected to reduce a country's fiscal space and thus enter the composite indicator with a negative sign. The meaningfulness of the indicator is questionable because some of the scores obtained do not accurately reflect a country's fiscal sustainability – for example according to this study, Bulgaria has a larger fiscal space than Germany and Finland, or Romania more room for manoeuvre than Sweden and Finland.

There are two main reasons for the apparent miscalculation of the indicator. First, the standardisation method of the indicator relies on z-scores.<sup>140</sup> This 'rewards' exceptional behaviour. A very good performance in few sub-indicators leads to a higher value for fiscal space than a lot of average scores. The low debt burdens in Romania and Bulgaria, for example, are likely to lead to an overestimation of the country's fiscal space. On a related note, it may be asked whether debt levels and payments of social benefits are a good indicator of a country's fiscal space. The Sovereign Debt Crisis has brought the old levels of debt sustainability (usually set at 60 per cent of GDP, in line with the Maastricht criteria) into bolder relief. Spain and

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<sup>140</sup> Z-scores are a standardisation method, which converts indicators to a common scale with a mean of zero and standard deviation of one.

Portugal faced financing difficulties, despite their economies being ‘widely seen as fundamentally solvent’ (Gros 2012: 37). Eastern European countries in particular have low debt burdens, which do not indicate high fiscal room for manoeuvre. Furthermore, the inclusion of social benefits is likely to introduce a bias in the indicator. First, by focusing merely on social benefits rather than social transfers in kind, the measurement is hardly complete. As Bamba (2005) and Adema and Ladaïque (2009) note, public expenditure in kind is a substantial part of the costs of the welfare state. More problematically, the link between the size of the welfare state and fiscal sustainability is dubious. On the one hand, Nordic countries are in particular famous for their generous social benefits without this negatively impacting their fiscal space. On the other hand, the comparative paucity of welfare state provisions in Eastern European countries should not be seen as a predictor of fiscal sustainability.

One way to correct the bias of sub-indicators would be to omit the best and worst sub-indicator scores from inclusion in the index or by assigning differential weights based on the importance of the sub-indicator scores. Secondly, given the high complexity of the estimation of a country’s fiscal space, it may be advantageous to create a larger set of sub-indicators from which to construct the fiscal space score. Seeking to obtain an appropriate indicator, I will introduce new sub-scores based on the EIP and use a different weighting strategy based on factor analysis.

### **Increasing the sub-scores**

Three elements of the Commission’s fiscal space composite indicator also appear in the scoreboard for the EIP. Amidst the European Sovereign Debt Crisis, a series of new regulations to enhance economic governance in the EU, proposed by the Commission, were agreed by the European Parliament and the Council. One of them, as part of the so-called Six-Pack, established a surveillance procedure to prevent and correct macroeconomic imbalances. Specifically, the new regulations established a

scoreboard to provide an early-warning signalling device of potentially harmful macroeconomic imbalances in Member States. Analogous to the SGP, the macroeconomic imbalances procedure has a preventive arm, where policy recommendations can be issued by the Council to tackle imbalances early on, and a corrective arm where ‘excessive’ imbalances have been identified and a corrective action plan is requested from the Member State concerned. Non-compliance with the Council recommendations can eventually lead to financial sanctions. In the ‘Scoreboard for the Surveillance of Macroeconomic Imbalances’ (DG Ecf. 2012), the Commission stresses that the indicators are neither policy targets nor policy instruments. Instead the results of the scoreboard are interpreted from an ‘economic perspective’, with thresholds for the indicators merely being a starting point to serve as alert levels. The scoreboard contains 10 indicators:

- 1) 3 year backward moving average of the **current account balance** as percentage of GDP, with a threshold of +6 per cent of GDP and -4 per cent of GDP;
- 2) **net international investment position** as a percentage of GDP, with a threshold of -35 per cent of GDP;
- 3) 5 years percentage change of **export market shares** measured in values, with a threshold of -6 per cent;
- 4) 3 years percentage change in **nominal unit labour cost**, with thresholds of +9 per cent for eurozone countries and +12 per cent for non-eurozone countries;
- 5) 3 years percentage change of the **real effective exchange rates** based on Harmonised Indices of Consumer Prices (HICPs) and Consumer Price Indices (CPIs) deflators, relative to 35 other industrial countries, with thresholds of -/+5 per cent for euro-area countries and -/+11 per cent for non-eurozone countries;
- 6) **private sector debt** in per cent of GDP with a threshold of 160 per cent;
- 7) **private sector credit flow** in per cent of GDP with a threshold of 15 per cent;
- 8) year-on-year **changes in house prices** relative to a Eurostat consumption deflator, with a threshold of 6 per cent;

- 9) **general government sector debt** in per cent of GDP with a threshold of 60 per cent;
- 10) 3-year backward moving average of **unemployment rate**, with the threshold of 10 per cent.

The scoreboard does not only identify potentially ‘harmful macroeconomic imbalances’ but also yields a useful indicator for the identification of fiscal sustainability, which is a country’s fiscal space. For the sake of clarity it is important to add that neither the purpose of the EIP nor its presentation in official documents establish the bridge between macroeconomic imbalances and fiscal sustainability. In an accompanying document (European Commission 2011) the Commission emphasises that ‘the sustainability of public finances will not be assessed in the context of the EIP given that this issue is already covered by the SGP’. The Commission did not want to be seen as replacing or weakening the existing EDP: ‘there may well be a loss of clarity, first we had only one clear indicator and now all of a sudden there are ten. What if the verdicts of the EIP are not in line with the EDP, which recommendations should Member States follow?’ (author interview, April 2011). Yet from an economic point of view the artificial differentiation between macroeconomic imbalances and fiscal sustainability is impractical. In its justification of the choice of indicators, accompanied by a comprehensive review of the literature (European Commission 2011), the link between each indicator and fiscal sustainability, default, and crisis incidences is meticulously presented.

Despite this reluctance, the EIP may be seen as a direct consequence of the main lesson of the European Sovereign Debt Crisis: ‘Fiscal profligacy is neither the sole nor the main origin of Europe’s fiscal crisis’ (Buti and Carnot 2012: 903). Critiquing the sub-scores of the EIP, Buti and Carnot (*ibid.*) argue that indicators of ‘fiscal vulnerability’ which take into account variables for financial and competitiveness developments give a better picture of risk of fiscal crises than purely fiscal indicators. A broader measurement of fiscal space/fiscal sustainability is needed to capture

relevant macroeconomic fundamentals. To obtain a ‘more complete’, theoretically grounded, measure of fiscal sustainability, I follow Knedlik and Schweinitz’s recommendation (2012) to ‘combine as many meaningful single indicators as possible into one composite indicator’.

### **A new fiscal space indicator**

One shortcoming of the Commission’s fiscal space indicator is that it fails to apply appropriate weights to the sub-scores. This is especially problematic given the likely presence of high correlation between the respective indicators. Factor analysis has however been established as a suitable weighting technique to deal with this issue.<sup>141</sup> The weights listed in the last column of Table A7.1 of the Appendix represent the final weight to be used for the fiscal space composite indicator.

These weights are then applied to the fiscal space sub-indicators based on the MIB scoreboard.<sup>142</sup> Note that the scores are not perfect predictors for the multi-causal outcome of fiscal distress. Notably, the comparatively high scores for Romania and

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<sup>141</sup> In the first instance, factor analysis is able to reveal how different variables change in relation to each other and how they are associated. Specifically, factor analysis transforms correlated variables into a new set of uncorrelated variables. In so doing it groups together individual indicators which are collinear, to form a composite indicator that captures as much as possible of the information common to individual indicators. Bear in mind that the weighting corrects for the overlapping information between two or more correlated indicators and is not a measure of the theoretical importance of the associated indicator. I follow the procedure described in OECD (2008) and begin with the full set of 10 variables of the EIP. The first step is to derive a set of eigenvectors and their associated eigenvalues, restricting myself to those components that are associated with an eigenvalue greater than one (as suggested by, for example, Jolliffe 1986). Next I checked the correlation structure of the data, to ascertain that correlation between the indicators is indeed strong. This is confirmed by the results of the Kaiser-Meyer-Olkin measure of sampling adequacy (.78). The second step is to generate the factors. Following existing practice I retain only factors whose eigenvalue is greater than one (Duntzman 1989:22-3), which leaves me with three factors. In the third step I compute the rotation of factors to minimise the number of individual indicators that have a high loading on the same factor. Rotation changes the factor loadings and hence the interpretation of the factors. Next I construct the weights from the matrix of factor loadings after rotation using the square of factor loadings, which represents the proportion of the total unit variance of the indicator, which is explained by the factor.

<sup>142</sup> For the composite indicator the individual scores are transformed into fuzzy sets ranging from 0-1 (stata command `setgen stdrank`). Note that the all findings related to the fiscal space indicator hold true if equal weights are used for the construction of the composite indicator to reflect the uncertainty about the origin of fiscal sustainability.

Latvia come as a surprise.<sup>143</sup> Although the overall fiscal situation of both countries was dire, they still scored highly on some of the indicators such as private debt, house prices and government debt. What is more, five out of ten of the fiscal space sub-scores take annual averages (3-5 years) and the brisk economic downturn that lead to liquidity problems is therefore less strongly registered than it would be with annual indicators. Note also that Romania and Latvia score well in the Commission's previous fiscal space indicator (EC 2009) as well as that of Aizenmann and Jinjarak (2012).

By and large however, the indicator (see Figure 7.3) is in line with what one would expect; Germany, Luxembourg, the Netherlands and Austria have the highest scores, whereas Portugal, Spain, Greece (which has the lowest score in 2009 and 2010), Hungary, Ireland, and Bulgaria have the lowest scores. Furthermore the EIP fiscal space indicator correlates negatively with a country's risk premium paid on government bonds.<sup>144</sup> In other words limited fiscal space is linked to higher interest rates. This is not to suggest that market participants are superior judges of fiscal sustainability; whether markets adequately price government bonds remains an open and contested question.

*Insert Figure 7.3 here*

### **Fiscal space and the size of stimulus spending**

Did a country's fiscal space correlate to the size of the fiscal stimulus package? Descriptive statistical analysis suggests that the answer is yes; Figure 7.3 summarises correlation results. There is a strong positive link between the size of the average

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<sup>143</sup> The Latvian government applied in late 2008 to the EU, IMF and regional neighbours for financial assistance amidst a rapidly deteriorating economic situation and short-term liquidity pressure linked to the ailing financial sector. Likewise Romania needed financial assistance.

<sup>144</sup> Measured as the interest rates paid on government bonds with 10 year maturity, for the 2008-2011 period (n=107, rho= -.35, significant at the .01 level).



fiscal space (2007-2010) and the size of the stimulus package as estimated by the Commission ( $n = 27$ ,  $\rho = .48$ )<sup>145</sup>. This finding is congruent with Cameron (2012), who shows that countries in which the government had a surplus in the years prior to the crisis generally made more substantial stimulus efforts. Put differently, countries with larger fiscal space such as Germany and Luxembourg implemented substantial stimulus packages, whereas countries with less fiscal space such as Greece and Ireland engaged in virtually no stimulus policies even before austerity conditionality in their rescue programmes.

A large mismatch between a country's individual fiscal space score and its stimulus package should not be seen as automatic evidence for free-riding behaviour. Taken together, it seems that member states implemented stimulus policies with their fiscal space in mind. Indeed the recommendation of the Commission makes a case for stimulus free riding if a member state has limited fiscal space. In its Report on Slovakia, the Commission (SEC 2009, 1276 final: 8) found the Slovak government's anti-crisis measures adequate given 'the limited fiscal space due to external imbalances'. In its recommendation on the existence of an excessive deficit (SEC 2009, 1271 final: 9), the Commission argues that Italian stimulus package is 'not expected to appreciably weigh on the government balance, as [it is] planned to have an overall neutral budget impact [...]. The package is an adequate response to the economic downturn in view of the very high debt ratio'. Along similar lines, in the assessment of the Belgian Stability Programme, the Commission points out 'that as a result of the openness of the economy, foreign packages should also contribute considerably to the recovery of the Belgian economy' (ECFIN/52791/09-EN). No EDP-related publication, be it authored by the Commission or the Council, encourages any of the 9 EERP non-compliers to shoulder more substantial stimulus measures. This is less evidence for successful coordination of fiscal crisis responses under the EERP, as for the accommodating EDP application in times of crises.

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<sup>145</sup> Significant at the .5 per cent level, results for the ECB stimulus estimations are virtually identical.

## Free-riding: Accusations and realities

The challenge of growth free-riding is not supported by the evidence presented in the preceding sections of this chapter. In addition to the quantitative evidence, all interviewees were asked about the occurrence of fiscal beggar-thy-neighbour policies; none thought of growth free-riding as a serious concern.<sup>146</sup> Member States with limited fiscal space that effectively abstained from discretionary spending, were not accused of growth free-riding. Ireland is a case in point. On 21 November 2010, Ireland officially requested financial assistance from the EU, the euro area Member States and the International Monetary Fund (IMF). In an emergency session of European finance ministers and officials from the ECB and the IMF, a joint financing package of €85bn was agreed (*Financial Times* 22.11.2010). In exchange, the Irish government agreed to ambitious fiscal policy and structural reform. In fact, Ireland had already begun consolidation measures in 2009, amounting to 5 per cent of GDP in 2009, followed by 2.6 per cent of GDP in 2010 (OECD 2011).

However three interviewees (author interviews, April and June 2011) pointed to Spain as an example where a country had clearly shot beyond its fiscal space in stimulating demand. The EIP fiscal space score corroborates this impression. According to this indicator, Spain had one of the EU Member States' worst fiscal space scores but one of the largest stimulus policies.<sup>147</sup> During 2008 and 2009, the Spanish debt burdens increased by 3 per cent of GDP due to direct bailouts of the financial sector and the government amassed a significant stock of liabilities linked to financial market support operations worth around €20bn (EC Public Finances

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<sup>146</sup> This finding might be biased due to the timing of interviews. A majority of interviews took place in the spring of 2011 when fiscal consolidation and concerns over the spreading Sovereign Debt Crisis dominated the calendar of the people interviewed. The focus was therefore likely on stability free-riding and not on growth free-riding. To corroborate the absence of growth free-riding accusations in interviews I systematically reviewed newspapers and official EU and domestic government documents of that period and also found no accusations of free-riding apart from the example of Germany which is discussed in the next paragraph.

<sup>147</sup> According to the EIP based fiscal space indicator, Spain is placed at the bottom four for the 2003-2010 period.

2010).<sup>148</sup> Crucially, both the Spanish government and the European Commission initially claimed that Spain had fiscal room for manoeuvre to engage in discretionary stimulus spending. During the first decade of the euro, the Spanish economy had been one of the fastest growing and most successful economies in Europe (Royo 2009). Presenting his government's stimulus policies in parliament, the then Prime Minister José Luis Rodríguez Zapatero argued that the Spanish government was in a strong position to stimulate the economy due to its relatively small debt burden and 'the fiscal prudence of the Socialist government over the past four years' (FT 28.11.2008). This optimism was echoed in the Commission's (EC 2009) evaluation of Spain's fiscal stimulus package, which although at first glance seemed excessive in the light of its output gap, was considered to 'be viewed in Spain's comparatively favourable fiscal space'. Dullien (2008) was one of the few cautious voices warning that 'a stimulus package in Spain risks just to cover up the country's economic problems without solving them'. In his opinion this amounted to a 'stimulus in the wrong country' (*ibid.*).

Fuelled by public disagreements between Sarkozy and Merkel, the free-riding debate of 2008/2009 focused on Germany. What stands out here is the discrepancy between allegations and realities of free-riding in the French and German fiscal crisis responses. Whereas the Sarkozy-led French government was seen as a motor for fiscal policy coordination both at the EU and the international level (Rommerskirchen 2011), the German government faced criticism for doing too little to stimulate domestic growth and obstructing economic cooperation. Within the EU, Sarkozy orchestrated numerous summits and sought a coordinated crisis response. Whereas Sarkozy was praised for his efforts, Merkel was dubbed 'Madame Non' in the international press because her government was not only hesitant in its domestic crisis response, but also because she was reluctant to call for all Member States to

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<sup>148</sup> This first wave of interventions in the financial sector was considerably less costly than the injection of €100bn into the banking sector under the financial assistance from eurozone Member States via the European Financial Stability Facility in the summer of 2012.

implement substantial stimulus programmes (*der Spiegel* 14.03.2009). In addition, she vetoed the plan for a more coordinated stimulus in the form of a general reduction of VAT, which the Commission had supported (Schelkle 2012a).<sup>149</sup> A *Financial Times* article (26.11.2008) called for EU officials to name and shame countries not pulling their weight, such as Germany and the Netherlands. Germany was accused of engaging in beggar-thy-neighbour policies, ‘waiting for other less well-placed countries to do most of the work and reaping the benefits once exports pick up’ (ibid). In addition to the difference in political status, the German and French economies were quite differently affected by the crisis. Export dependency and the current account position is one of the main factors in determining the contraction of the economy (Commission 2009). In particular Germany, the Netherlands, and Austria, where export demand had been strong, were more exposed to the contraction in world trade. The sharp decline in German exports had a devastating effect, notably on investment in plant and machinery, which fell by 21.8 per cent in the first six months of 2009 alone (Zolnhöfer 2011). The *Economist* (7.5.2009) claimed that with the export-led model sputtering more than most in times of recession, ‘the title of export champion may have lost its glitter’. Along similar lines, in a speech in front of the G20, Sarkozy (2009) prided himself that the ‘French economy is holding up better than those of its major partners’. Although this portrait of an ailing German economy and a resistant French economy was short-lived (see below), it shaped the free-riding discourse during the Great Recession.

Against this backdrop, the realities of stimulus spending hardly live up to the free-riding discourse. Germany had one of the largest stimulus packages both in absolute and in relative terms. Notably it announced a first set of stimulus measures prior to the EERP agreement. When asked how far EU pressures and agreements shaped Germany’s crisis response, interviewees across the board were sceptical as to

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<sup>149</sup> The remark of the then German finance minister, Peer Steinbrück (2008), who called the UK’s cut in VAT ‘crass Keynesian’ should be seen as a reaction to his government’s position against similar EU-wide tax cuts.

whether they mattered at all; ‘do you really think German politicians needed someone to tell them that they should help their automotive industry?’ (Author interview, March 2011). Yet the initial announcements of stimulus programmes were timid (by December 2008 France had announced a €39bn plan, whereas the German package pledged only €12bn; Spilimbergo *et al.* 2008). Arguably, German policy-makers are largely responsible for this misconception of a passive government due to their reluctant embracing of Keynesian style demand-management and inconsistent communications as discussed in chapter five. If accusations of free-riding were not justified given the size of the stimulus packages, they were certainly provoked by a government that in public refused to acknowledge the need for discretionary fiscal spending. Most of this reluctance stems from domestic paradigms of macroeconomic policies. There is however also a European dimension to the repeated disavowals of stimulus spending. The German government initially opposed the EERP, as it would encourage ‘states to spend money that they do not have’ (author interview, March 2011).

The EERP came at a time when German policy-makers were concerned with a restoration of the SGP at the EU level and a reaffirmation of Germany’s position as a paragon of fiscal prudence. During the 2005 election campaign, reinvigorating the SGP on a European level and fiscal prudence on a domestic level were essential elements of centre-right CDU election strategy. Merkel demanded ‘a new Stability Culture’ during election rallies (*der Spiegel* 14.09.2005) and the election manifesto of the CDU declared to ‘put an end to the calamitous march towards the debt state’, the need for ‘strict fiscal discipline’ and ‘no shaking of the SGP’ (CDU *et al.* 2005). The new fiscal course for the Grand Coalition which came to power in autumn 2005 can be found in the joint contract between the CDU, CSU and SPD: ‘Consolidating the budget and meeting the Maastricht deficit criteria by 2007 is indispensable’ (Koalitionsvertrag 2005). Reinforcing the SGP, it would be a logical step for German politicians to publicly renege political ownership of the EERP.

Two recent analyses comparing the French and the German crisis responses to the Great Recession suggest that while the German stimulus was adequate (albeit poorly communicated), the French stimulus was arguably sub par (see Table 4.1). Schelkle (2012a: 5) argues that despite the fact ‘the French asked for decisive joint action’ [...] ‘in practice, the French government relied heavily on the in-built stabilisers of their tax-transfer system with largely symbolic extra spending’. Vail (2012: 10) argues that the modest French stimulus ‘was particularly surprising given France’s relatively dire economic situation’, shown by French and German unemployment rates (9.5 per cent and 7.8 per cent of GDP in 2009). The underlying logic is perhaps flawed. First, the author cites only the 2009 figures, whereas the difference for 2008 is less stark (7.8 per cent in France and 7.5 per cent in Germany). More importantly, the causality of unemployment rates and stimulus spending is not unidirectional as Vail assumes. In other words the German stimulus was not high despite low unemployment rates, but unemployment was kept at bay because of generous stimulus spending. The German *Kurzarbeit* (short-term work) programme, for example, is estimated to have subsidised more than 1.5 million employees, ‘which helped keep unemployment relatively low’ (Zohlnhöfer 2012). Furthermore, the unemployment rate is, albeit an important, not the sole trigger for stimulus policies. On the one hand, the German economy was particularly severely affected if one looks at other indicators such as GDP or the output gap. On the other hand, France was able to cushion the recession better than other EU countries. Moreover, if one accepts the notion of fiscal space dependent stimulus, then the French response was in line with its fiscal room for manoeuvre. Despite being less vulnerable to the decline in export markets, the French economy faces considerable structural challenges, which may threaten the long-term sustainability of public finances (European Commission 2012).

The French government is not the only one to have ‘play[ed] up the extent of intervention’ (Schelkle 2012b). In November 2008, the Italian prime minister announced an €80bn stimulus package (*Financial Times* 30.11.2008). This (fictional)

figure was widely circulated not only in public speeches but also official documents such as the country's annual Stability and Convergence Report: 'The Government aims to mobilise resources of roughly €80bn, through the resumption of a series of investment projects and active use of the Cassa Depositi e Prestiti (CDP),<sup>150</sup> consistent with its view that, in the short run, fiscal stimulus is needed to support demand and growth' (Italian SCP 2009). Yet, official estimates show the Italian stimulus to be virtually non-existent (estimated at 0 by the ECB and the OECD, and at 0.3 per cent of GDP by the IMF). In light of Italy's limited fiscal space (see Table 7.3), the absence of a *de facto* stimulus package was welcomed.<sup>151</sup> As one interviewee said: 'We were quite relieved that Berlusconi's big announcements amounted to nothing more than hot air' (author interview, April 2011). In the Council's 2009 country recommendation it notes that 'given the already very high debt ratio, any large budgetary deterioration could elicit a reaction from the financial markets, causing a further widening of the already significant spreads between Italian and German bonds. This would result in higher interest rates for the entire economy, outweighing the benefits from the fiscal stimulus.'

The public charges of German stimulus free-riding were eventually dropped given its substantial discretionary spending, merely to be replaced by a new kind of beggar-thy-neighbour accusations.<sup>152</sup> In 2010, French criticism of the strong German trade surplus made headlines amidst clear indicators that the recovery of the German economy was stronger than that of France. Jean-Paul Fitoussi, then adviser to Sarkozy, argued that 'the German economic strategy built on growth of exports is

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<sup>150</sup> The CDP is a joint-stock company under public control with a major role in public investment projects (Salvemini 2007).

<sup>151</sup> Italy faced record high borrowing costs in 2011 amidst domestic political tensions and contagion starting with the Greek Sovereign Debt Crisis.

<sup>152</sup> Likewise at the international level a growing interest surrounding global imbalances took place at the G20. The debate within the G20 focused almost entirely on the two biggest surplus countries, dubbed 'Chermany' by the media, China and Germany (*Financial Times* 16.3.2010). The US delegation sought to discuss imbalances first and foremost to put pressure on China to appreciate the renminbi faster. 'Originally the issue of imbalances was a way for the US to bash China within the G20, yet for political reasons the Obama administration did not want to single out China and therefore Germany got in the line of fire as well' (author interview 12.4.2011). The German government therefore faced criticism for its strong export model both at the EU and the international level.

uncooperative' (*Financial Times* 16.2.2010). Christine Lagarde, then Finance Minister, urged the German government to boost domestic consumption to help current account deficit members in the eurozone (*ibid.*). Again, the communication of Germany's government was not particularly sensitive. In an online presence (Germany Trade & Invest)<sup>153</sup>, the Economic Ministry maintains a list of stimulus packages in over 60 countries to help the German 'Mittelstand'<sup>154</sup> to seize opportunities to enter new markets and thus emerge with new strength out of the economic crisis' (see also Schelkle 2012). Specifically, the website offers detailed descriptions of stimulus programmes including the relevant sector and contact information. If however German policy-makers had any free-riding intentions, it seems odd that they vocally denounced the effectiveness of stimulus spending. Franzese and Hays (2008: 5) portray free-riding as arising because of policies being strategic substitutes, that is 'when policy changes in one jurisdiction create incentives for governments in others to adopt change in the opposite direction'. In the case of fiscal stimulus policies, this means that the increased expenditure of one country in response to the crisis, leads to less stimulus spending in another country, given the possibility of (especially for small and open economies) free-riding. The German efforts to dissuade other countries from stimulating their economies therefore runs contrary to the claims of Germany's free-riding tactic.

## Conclusion

Despite severe problems of communication, accusations of stimulus free-riding are not borne out by factual evidence. The findings of this chapter suggest that countries with open economies, a larger population and a larger economy implemented larger stimulus programmes. This is in contrast to the literature, which presents these as characteristics of both a bigger capacity and incentive to free-ride on group-oriented behaviour. What is more, countries with limited fiscal space, as set out in the EERP,

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<sup>153</sup> The page in question has been taken down as of December 2012.

<sup>154</sup> The German Mittelstand comprises Germany's small and medium-sized enterprises.



by and large abstained from large stimulus programmes. This is an important finding since it suggests that Member States did shoulder more or less stimulus burden depending on their economic means - thereby eschewing uniform contributions across Member States. With the benefit of hindsight, the effective growth free-riding of countries with limited fiscal space should be seen as preferable to an otherwise likely scenario of stability free-riding. An exception to this trend is Spain. The generous – and from EU-officials, approved – Spanish stimulus shows that stability free-riding was simply not a dominant concern of fiscal policy coordination in the EU prior to the outbreak of the Sovereign Debt Crisis. This is in line with the presentation of the EERP as a *carte blanche* for deficit spending.

The main accusations of growth free-riding were levelled against the German government. Benefiting from other Member States stimulus programmes, and actively seeking to do so as the call from *Germany Trade & Invest* suggests, is something that net exporting countries are structurally better positioned to do than net importing countries. Yet it is not the same as free-riding. This chapter has shown that given the substantial German stimulus, the government certainly contributed its share to the production of the collective good.<sup>155</sup>

The free-riding debate of 2008/2009 marks a shift in EU fiscal policy coordination, given that the Maastricht Treaty coordination aimed at restraining deficits and reducing debt levels. Various charges of stability free-riding have thus dominated the political landscape. The Great Recession has changed this. Firstly, German politicians' belated embracing of stimulus measures as a response to the sharp economic downturn has cast Germany as a free-rider on other Member States' stimulus efforts. Secondly, it became clear that, after a decade of sluggish growth and painful economic adjustment, the German economy weathered the crisis better than most of its EU partners. This comparatively easy, export-fuelled recovery, in parallel

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<sup>155</sup> Although the characterisation of this contribution as the 'lion's share' (Steinbrück 2009) seems exaggerated.

with the on-going fiscal crisis in Greece, Spain, and Portugal, has caused macroeconomic imbalances to gain prominence in the EU's nascent economic governance.

One might argue that the post-Great Recession policy coordination has reached a free-riding equipoise, which recognises both growth and stability free-riding as potentially harmful behaviour, whereas the pre-crisis EU was mainly focused on stability free-riding. Given the rising inequality within EU Member States' economies, charges of free-riding are likely to remain a constant feature of the struggle for policy-coordination in the EU.

## CHAPTER 8: CONCLUSION

### Introduction

This thesis contributes to the wide literature on EU fiscal policy coordination by focusing on the challenges of fiscal policy coordination in ‘hard times’ during the 2008-2010 period. Fiscal policy during the Great Recession was not coordinated; Member States adopted largely unilateral fiscal crisis responses. In so doing, national governments showed little concern for EU-level agreements or EU-wide stability and growth. Yet despite this lack of coordination, which represented ‘a significant modification of national policies in recognition of international economic interdependence’ (Wallich 1984: 85), I find no strong evidence for free-riding behaviour. On the one hand, the overarching consensus on the need for counter-cyclical fiscal policies prevented growth free-riding (i.e. stimulating too little). On the other hand, discipline imposed by financial markets contributed to policy-makers’ awareness of their limited ‘fiscal space’, which meant that by and large, stability free-riding (i.e. stimulating too much) was not an issue either. The first finding speaks to the importance of shared policy ideas in achieving collective action, whilst the second highlights the role of financial markets in constraining fiscal policy.

This concluding chapter will proceed as follows: I begin with a summary of the key findings of this thesis, before turning to a discussion of future developments in fiscal policy coordination. I argue that as ‘stressful heterogeneities’ between EU Member States are increasing, the importance of Olsonian incentives to induce group-oriented fiscal policy outcomes will increase. Next, I examine the wave of economic governance reforms post-2011, which currently prioritises concerns of stability over growth free-riding. However, some elements of the new economic governance architecture, particularly the Macroeconomic Imbalances Procedure (MIP), may pave

the way towards a comprehensive system of macroeconomic policy coordination that covers both forms of free-riding. I will then analyse the emergence of a new paradigm for fiscal policy coordination, which may provide an incentive for collective action. Whilst such a paradigm extension could address both stability and growth free-riding, the forces of market discipline are point exclusively to the former. In a third section, I discuss market discipline and stability free-riding post-2011 and seek to chart some of the future challenges and tensions in financial-market-sovereign state relations. This chapter will conclude by challenging the claim of the powerless EU Member State (cf. Martin 1998).

### **Key findings**

The EU-level framework for fiscal crisis responses, the European Economic Recovery Plan (EERP), is introduced in Chapter 1. This recovery plan sought to provide a programme for counter-cyclical policies amounting to a total of 1.5 per cent of EU GDP (1.2 per cent of GDP at the national level) to mitigate the global economic fall-out of the international financial crisis. After decades of championing low deficits and debt levels, the Commission emerged as an unlikely advocate of stimulus policies throughout the European Union, calling for a relaxation of the application of existing rules under the Stability and Growth Pact (SGP). The crisis framework laid out in the EERP presented an attempt to coordinate not fiscal constraint, but for the first time fiscal expansion. With the declaration that ‘[w]e sink or swim together’, the EERP (2008) provides a clear economic rationale for the coordination of fiscal response strategies – interdependence. The basic argument in favour of fiscal policy coordination, presented in Chapter 2, is found in the need to internalise the externalities arising from spillover effects. Fiscal policy is treated as a matter of common concern and its coordination thus emerges as a means to achieve outcomes in a more efficient and optimal manner. This is particularly true for eurozone Member States sharing a common monetary policy. In times of crisis the externalities of fiscal policy choices are potentially bigger due to an increased scope

for government action. The challenge for fiscal policy coordination during the Great Recession was then to prevent two types of free-riding behaviour. The first type, growth free-riding, regards benefiting from other countries' expansive fiscal policies. The second type, stability free-riding, considers the hazard of too much fiscal expansion, which might threaten the stability of the eurozone in particular and the EU more generally. Prior to 2008, fiscal policy coordination was seen as a means to prevent stability free-riding and, more concretely, to prevent monetary or fiscal bailouts. This changed during the Great Recession. On the one hand, the economic fallout prompted a brief 'Keynesian moment' in the EU, as well as across the developed and developing world. This brought the coordination of stimulus packages, and consequently concerns over growth free-riding, to the top of the EU fiscal policy agenda. On the other hand, the recession of 2008 and, even more forcefully, the EU Sovereign Debt Crisis have brought the so-called 'Sound Money paradigm' into bold relief. Macroeconomic stability could no longer be reduced to low inflation rates and low deficit levels. This led to a reappraisal of what sound fiscal, and more broadly sound macroeconomic policy constitutes of. Forging a new policy paradigm, the old schism between good fiscal policy (low deficits) and bad fiscal policy (high deficits) has come under attack. Indeed the notion of growth free-riding was institutionalised alongside a strengthening of stability free-riding provisions (see below).

Chapter 3 discusses the conceptual framework, research hypotheses and methods employed in this thesis, beginning with an introduction to the theoretical centre of this research: collective action theory. Olson's (1965) body of work is the starting point of the three main hypotheses considering the EU's group latency, incentives for collective action and free riding behaviour. These hypotheses follow systematically from a three-step testing design. In a first step I examine whether, in terms of fiscal policy coordination, EU Member States can be characterised as forming a latent group for which collective action is inherently challenging. Specifically, I am able to draw inference on group latency by identifying the determinants of fiscal policy

outcomes. The existence of group latency is said to render the provision of separate and selective incentives necessary in order to motivate group members to contribute to the production of the collective good in question. Hence, in a second step I analyse the working of different separate and selective incentives, identified in fiscal rules/ fiscal policy agreements and market discipline. Here the focus is on whether or not these incentives mattered for public finances in times of crises. Weak incentives, in turn, would imply a high likelihood of free-riding behaviour – collective action failure. The third hypothesis of this thesis therefore considers evidence in favour or against stability and growth free-riding during the Great Recession. These hypotheses are tested using a mixed-methods approach consisting of qualitative and quantitative approaches. This combination of nuanced interview material with arguably more blunt econometric techniques demonstrates the methodological pluralism embraced in this thesis.

Before engaging in hypotheses testing, Chapter 4 considers different measurements for fiscal policy outcomes for the timeframe of this thesis. Finding appropriate indicators that are able to reflect fiscal crisis responses is challenging given the substantial size of automatic stabilisers, dubious aggregation techniques used to compile stimulus figures and the debatable accounting standards of financial sector rescue operations. Meeting these challenges, this study adopts a centripetal measurement approach, relying on different measures with diminishing policy discretion. The four dependent variables measuring fiscal policy outcomes are the budget balance, the primary budget balance, the structural balance and the primary structural balance.

Chapter 5 sets out to examine the determinants of fiscal policy outcomes and tests whether or not the EU can be, in terms of fiscal policy coordination, considered a latent group. In so doing, I analyse time-series cross-sectional data from the 27 EU Member States over a 3-year time period (2008-2010). The empirical analysis confirms that the deficit bias attributed to contemporary public finances was stronger

during the Great Recession and that political factors have indeed shaped public finances. I argue that fiscal policy outcomes were not apolitical products of the harsh economic logics of compulsion, but a complex result of intervening political features. Faced with a common shock, Member States responded not merely to the economic imperative of crisis management, but identified different solutions to similar problems, which were co-determined by the political landscape: namely the electoral calendar, political fragmentation and executive partisanship. The heterogeneity of political conditions has implications for the latency of the EU Member States and in turn the coordination of fiscal policy choices. Member States without election years falling in the 2008-10 period for example, were more likely to implement smaller stimulus programmes than Member States where policy-makers faced the electorate imminently. Conversely, right-leaning governments were more likely to have designed larger stimulus plans than their left-leaning counterparts. This suggests that being part of a latent group, Member States may have either under- or over-stimulated their national economies, depending on their political profile.

Solutions to free-riding, be it stability or growth free-riding, are thought to be found in the provision of separate and selective incentives. Chapter 6 tests the second hypothesis, namely whether separate and selective incentives kept free-riding at bay. Specifically, I analyse two types of incentives, which are thought to affect fiscal policy outcomes: fiscal rules and market discipline. The empirical findings suggest that domestic fiscal rules, such as debt brakes, did not impact on the fiscal policy responses to the Great Recession. Similarly, EU level fiscal agreements, the SGP and the newly created EERP, did not impact on fiscal policy choices. I argue that these findings do not come as a surprise. First, the majority of domestic fiscal rules were equipped with exceptionality clauses. As a result, they did not impose stern constraints on fiscal policy choices in times of crises. And even where those escape clauses were not in place, policy-makers loosened the rules to enable them to mitigate the economic fallout. Secondly, the role of EU rules and agreements in shaping fiscal policy choices has been placed under scrutiny ever since the creation

of the SGP. The vague commitments under the EERP and the generous implementation of the EDP further speak to the reluctance of sovereign policy-makers to coordinate fiscal policy in ‘hard times’. Wyplosz’ conclusion (2013) that there ‘has been zero effort at coordination’ seems somewhat harsh, especially in light of numerous crisis summits, the agreement on the EERP and the Commission’s subsequent monitoring of stimulus packages. In this thesis I argue instead that the efforts of fiscal policy coordination during the Great Recession were lacking in success.

It would be a mistake to assume that just because Member States predominantly resorted to an increase in public expenditure to combat recession, these policy choices were driven by EU-level incentives. Instead, discretionary stimulus spending as a response to the economic downturn seems to have been a default option for developed, and to a lesser extent developing countries (e.g. Velde 2011). I argue that in terms of fiscal policy outcomes, the EERP was meaningless; Member States essentially adopted stimulus programmes as they saw fit with little concern for EU-level agreements or EU-wide aims of stability and growth. This assessment is echoed by Verdun and Heipertz (2010:189) who describe the overall approach to fiscal policy coordination during the Great Recession as ‘one of pronounced national action and limited European coordination, the communication of which bordered on the meaningless’. Despite its deficient steering power for public finances in times of crises, the EERP was a meaningful policy-choice for the Commission. The EERP created an ad-hoc *Sollbruchstelle* (Lohmann 2003) to excuse non-compliance with the SGP and uphold the appearance of fiscal policy coordination.

In contrast to fiscal rules and intergovernmental agreements, the incentives provided by market discipline (measured as interest payments) are found to have an impact on fiscal crisis responses. Importantly, this effect is stronger for eurozone Member States, who suffer from original sin (cf. Eichengreen and Hausmann 2005) and whose fiscal policy choices and outcomes are viewed more critically by financial



market participants. In contrast to budgetary rules and the EERP, market discipline offers both stick and carrot, via a change in borrowing costs. I argue that key to the disciplinarian success of market discipline is the fact that it is not faced with the second-order free riding problem (Oliver 1980), i.e. it is not a decentralised incentive provided within the collective action group. Markets do not punish governments primarily to prompt budgetary consolidation – market punishment is a by-product of risk pricing. These findings suggest an asymmetry; whereas stability free-riding was punished by the existence of separate and selective disincentives in the form of market discipline, growth free-riding was not subject to effective (dis)incentives, be they in the form of market discipline or fiscal agreements at the EU and domestic level.

Building on the findings of group latency and asymmetric incentives to induce group-oriented behaviour, Chapter 7 tests whether fiscal policy coordination was marred by free-riding. Specifically, both stability and growth free-riding behaviour are investigated. The central claim of this chapter is that accusations of stability or growth free-riding are not borne out by factual evidence. Given that markets provided an Olsonian incentive against stability free-riding, growth free-riding is expected to be more prevalent. First, I rely on fuzzy Qualitative Comparative Analysis to show that despite their greater ability to free-ride, larger and more open economies implemented larger stimulus programmes. To better distinguish between growth and stability free-riding, I consider fiscal response strategies *vis-à-vis* a country's fiscal space. This allows me to ask whether countries stimulated too much in relation to their small fiscal space (stability free-riding) or too little in relation to their large fiscal space (growth free-riding). In so doing, I construct a new composite indicator based on the EU's Excessive Imbalances Procedure (EIP) and correlated its score with Member States fiscal crisis responses. Results show that, by and large, Member States stimulated their economies in line with their fiscal room for manoeuvre as laid out in the EERP. These findings are contrasted with the political

discourse of late 2008 and 2009, when accusations of growth free-riding were widespread.

### **Stressful heterogeneities and the future of fiscal policy coordination**

Fiscal policy concerns the collection and distribution of revenue across people and generations; it is at its core political. Thus it is hardly surprising that setting, or perhaps more to the point respecting, upper and lower limits for public finances is a formidable task for EU Member States – no matter how urgent or compelling the underlying logic of interdependence may be in suggesting a need for (greater) fiscal policy coordination. I have argued that fiscal policy outcomes do not emerge in a political vacuum, but are instead best described by a host of what are often called ‘political-economy’ factors emerging from the interplay of politics and economics. Economic conditions in Europe, although not granted explanatory sufficiency or in some instances even primacy, set the scene for fiscal policy coordination. Ever since its creation the EU has aspired to cosmopolitan liberalism that is ‘united in diversity’. The past crises have revealed the limits of applying this motto to an ‘ever closer’ economic and monetary union, as the destabilising effects of a diversity found in macroeconomic imbalances became apparent. Economic diversity is increasing: in 2012 growth developments in the EU diverged more strongly across Member States than in the previous years (European Commission 2012).<sup>156</sup> While some Member States’ economies are growing, others still remain in, or are re-entering, recession. Yet this disparity points to more than just different economic growth trends; it is indicative of vastly different political challenges facing EU policy-makers in times of enduring financial instability and fiscal consolidation. The obvious division line separates debtor (programme) and creditor countries (cf. Dyson 2010), in addition to old parameters (eurozone and non-eurozone, north and south, core and periphery, old and new Member States). Different country groups have vastly different, even

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<sup>156</sup> See also Orriols (2013) on the merging ‘ideological divorce’ in the EU.

diametrically opposed, views on the scope and directionality of fiscal policy coordination, as well as the importance of and remedy for growth or stability free-riding. Given the growing trends of fiscal adjustment and economic growth, that is growing ‘stressful heterogeneities’ (Varughese and Ostrom 2001: 762), it is unlikely that the latency of EU Member States will decrease in the near future. Building on Olson (1965), Member States would be well-advised to look for ‘innovative institutional arrangements well matched to their local circumstances’ (*ibid.*) in order to overcome these heterogeneities. Indeed, EU Member States have set out to reform economic governance and complemented the institutional arrangement in place to boost not only fiscal but also economic policy coordination more broadly.

### **SGP 3.0**

The key reform piece, the so-called ‘Six Pack’, denotes a new set of rules for fiscal and macroeconomic surveillance in the EU. On paper, the Six Pack potentially strengthens the role of the Commission in both the corrective and the preventive arm of the Stability and Growth Pact. Much has been written about the possibility of sanctions under the EDP with the newly introduced reversed majority voting (e.g. Chang 2013; Hodson 2013b; Palmstorfer 2013). Specifically, the Commission recommendations to impose sanctions under the EDP may be over-ridden by the Council only by qualified majority. This modification harks back to 2003, when the Council voted to suspend the Commission’s recommendation to launch an EDP against France and Germany. Overriding the Commission is still possible; doing so simply requires a larger coalition of Member States.<sup>157</sup> There is little reason to assume that SGP 3.0, as Larch *et al.* (2010b) call it, will exert more substantial pressures. The recent experience of the EDP shows that Member States are cautious not to escalate the procedure and avoid moving it up to the newly introduced reverse

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<sup>157</sup> It is speculative to assume that the 2003 vote in favour of Germany and France would not have succeeded under qualified majority, given that voting was endogenous to the threshold in place.

majority voting (Hodson 2013b).<sup>158</sup> Crucially, reverse majority voting is not extended to all decisions taken by the Council. The key decision to place a country under EDP in the first place continues to be governed by the old qualified majority process. Since (re-)opening a wave of EDPs in 2008-2009, the delayed deadlines for correction of the excessive deficit have been set and generously revised, which involves commending EDP countries for having ‘complied’ with Council recommendations. The corollary of this practice may well be that ‘peer pressure’ erodes further as Member States congratulate themselves on actions taken. In sum, fiscal policy coordination under the SGP 3.0 remains subject to political capture by the Council.

### **Domestic fiscal framework**

Reinforcing domestic fiscal frameworks has emerged as a key response to the fiscal legacy of the crisis. Member States have been urged to strengthen domestic fiscal rules in line with the SGP ever since the 1990s. Indeed following the Commission’s recommendations, the Ecofin Council had repeatedly advised on the creation of a ‘national stability pact’ in Germany to boost compliance with the SGP prior to the Great Recession.<sup>159</sup> With the Fiscal Compact (the Treaty on Stability, Coordination and Governance),<sup>160</sup> participating Member States committed to government budgets being at least close to balance in structural terms. Although the Stability and Growth Pact includes very similar requirements, the Fiscal Compact requires the inclusion of ‘German style’ debt brakes in national law. The solutions identified in the Fiscal

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<sup>158</sup> It is telling that in the case of Hungary, the Council decided in 2012 to freeze its EU structural funds because Hungary did not take the necessary steps to correct its excessive deficit. Yet this move was more concerned with the democratic values of the EU, which were considered under threat by the nationalistic Orban government (see Johnson and Barnes 2013), than with concerns over fiscal policy coordination.

<sup>159</sup> See ‘Council opinion of 28 February 2000 on the updated stability programme of Germany for the period 1999 to 2003’ and ‘Council opinion of 27 November 2000 on the updated stability programme of Germany for the period 2000 to 2004’.

<sup>160</sup> The intergovernmental Fiscal Compact was signed by 25 Member States (all EU countries except the United Kingdom and Czech Republic) on 2 March 2012 and entered into force on 1 January 2013 following its ratification by Finland (the twelfth Member State to do so).

Compact offer an old disciplinarian remedy to fiscal policy coordination and are biased towards preventing stability free-riding. A more comprehensive ‘fiscal governance’ approach, championed by the Commission (2006, 2009, 2010a, 2010b), also considers the role of independent fiscal institutions. As the Swedish case considered in Chapter 6 has shown, such a body of independent auditors may not only reign in creative accounting and overly optimistic forecasting (Hagemann 2009), but can also address growth free-riding. That is to say, Fiscal Councils can offer a more balanced approach, considering not only the necessity for fiscal constraint but also the merits of fiscal expansions.

Critics of the Fiscal Compact have pointed out that the debt brake’s cyclical component will render it open to political manipulation (Cottarelli 2012; Hamker 2012; Truger and Will 2012). What is more, there is compelling evidence that this type of numerical ceiling is not equally efficient for all types of governments (Hallerberg *et al.* 2009).<sup>161</sup> And even where the fiscal governance mode corresponds to a country’s polity, it is not clear that ‘debt brakes’ provide a fiscal cure in the light of endemic financial instability and growing macroeconomic imbalances. Spain offers a case in point; in line with its underlying political environment, the country moved to a delegation mode of fiscal governance in the early years of the euro and implemented a debt brake which covers 100 per cent of general government finances – far more than the 53 per cent currently covered by the German debt brake. In Spain, gross central government debt as a percentage of GDP has risen from 40.2 per cent in 2008 to 91.3 in 2013. More broadly speaking, advances in fiscal rules have clearly not effectively counteracted developments in debt levels post 2007. Whereas the average Fiscal Rules Index improved steadily from -.66 in 1997 to .53 in 2011, debt levels have arrived at an all-time high (with an EU average of 83.1 per cent of GDP in 2011). As Chapter 6 has highlighted, in times of economic and financial

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<sup>161</sup> According to Hallerberg *et al.* (2009), the suitability of fiscal governance types hinges on the prevailing type of government in a given state. Single majority governments, regularly present in majoritarian electoral systems, should have a different type of fiscal governance than coalition governments, unusually present in highly proportional electoral systems.

crises, fiscal rules tend to fall by the wayside to make room for stimulus policies or, in many instances more importantly, financial sector rescue packages. Without addressing the underlying causes for exploding debt levels, which a ‘common pool’ view of public finances alone cannot account for, there is little reason to assume that the debt brake solution will go a long way towards improving compliance with the SGP.

The economic governance reforms of 2011-2013 have fallen ‘short of what the Commission itself had initially supported’ (Cottacorelli 2012: 370) and fail to create a system of strong separate and selective incentives to overcome stressful heterogeneities. In this thesis I argue that institutional arrangements during the Great Recession were weak; neither domestic nor EU-level agreements on fiscal policy outcomes provided a meaningful incentive for group-oriented behaviour. However shared policy ideas on public finances, as well as market discipline, have been shown to restrain free-riding behaviour. Firstly, a broad consensus on the need for stimulus politics to boost demand by and large meant that Member States did not free-ride on other countries’ discretionary spending despite having the fiscal space to introduce stimulus packages themselves (i.e. growth free-riding). Second, the discipline imposed by financial markets’ sovereign risk pricing meant that Member States were constrained in their stimulus efforts and by and large did not introduce stimulus packages that exceeded their fiscal space (i.e. stability free-riding). Both can thus function as a substitute for strong institutional commitment to shape group-oriented behaviour.

### **A new paradigm for fiscal policy coordination?**

It would be precipitous to seek to arrive at a verdict on the overall impact or significance of the Great Recession in terms of a new fiscal policy paradigm. Yet, it is not premature to identify emerging patterns and to consider their potential importance for the future of EU fiscal policy coordination. The paradigm adaptation

prompted by the upheaval of the economic and financial crisis can be best described as a paradigm expansion. This expansion covers two interrelated aspects. First, fiscal policy coordination during the Great Recession was for the first time concerned not only with the mutual management of coordinated constraint but also of coordinated expansion. Second, the old consensus on the ‘sound money and finance paradigm’ (also called ‘Great Moderation’ paradigm) has not survived the economic fallout unscathed. Faced with its limitations in explaining, let alone preventing, the European Sovereign Debt Crisis, policy-makers at the domestic and EU level were increasingly looking for more nuanced guidelines on macroeconomic management.<sup>162</sup> As will be discussed below, both characteristics are reflected in the post-crisis reforms and in the first round of fiscal policy coordination under the new economic governance framework.

### **After the Great Moderation**

The onset of the financial crisis in 2008 has been widely heralded as a fundamental challenge to models of neoliberal governance. As Peck *et al.* (2010: 94, own emphasis) put it, ‘[n]ever before has the question of neoliberalism’s political, economic, and social role – culpability might be a better word – been debated with such urgency, *so globally*, and in such a public manner’. Within the G20, for example, the broadening of the Great Moderation paradigm was expressed by the newly created Mutual Assessment Process (MAP), which essentially establishes a toned down version of the EU Macroeconomic Imbalances Procedure (Rommerskirchen 2011). The search for ‘better’ policy paradigms and lessons to draw from the economic fall-out in the wake of the Great Recession can thus hardly be portrayed as an exercise confined to the EU. Yet the EU stands out in this quest in that it responded to the challenges to the Great Moderation paradigm with an institutional reform unparalleled at the international level. Indeed the Great

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<sup>162</sup> Financial regulation is experiencing a comparable paradigm adaptation described under the heading of ‘macro-prudential regulation’ (Baker 2012).

Recession, and the Sovereign Debt Crisis in particular, has triggered the most substantial economic governance reform since the Maastricht Treaty. The Six Pack institutionalises a paradigm expansion, which can be referred to as ‘the Great Stability’ paradigm. The past crises have refuted the existing belief that the sound fiscal (according to the SGP) and monetary policy (according to the ECB) would ensure macroeconomic stability. Of course, for all EU Member States but Greece, the fallout during the crises years was not a direct result of fiscal profligacy. This obvious finding is at odds with the German remedy to the two interrelated crises, which championed fiscal rules (as defined in the Fiscal Compact) and a commitment to a renewed Stability Culture (meaning low inflation and low deficits) as the panacea for the EU’s current woes (Howarth and Rommerskirchen 2013). Yet there is reason to believe that the German “Stability Culture view” of economic stability is losing support in Europe. Within academia there is a broad consensus that neither the financial crisis of 2008 nor the Sovereign Debt Crisis can or should be cast as a cautionary tale of governments living beyond their means (e.g. Armingeon and Baccaro 2012; Blyth 2013; de Grauwe 2013; Streek 2013). Moreover within the Commission, the political business cycle theory of exploding debt levels (Buchanan 1958) is losing ground. This is perhaps clearest in Buti and Carnot’s article (2012) on the early lessons and reforms of the EMU Sovereign Debt Crisis. Indeed since the eruption of the financial and economic crises in 2008, the Commission has considered the Great Recession as a multi-layered crisis (see European Commission 2009) and the dramatic increase of government deficits and debt as ‘not essentially of a fiscal nature’ (European Commission 2012: 67). Looking beyond ‘fiscal indicators’, addressing the causes and consequences of ‘imbalances’ has, once again (Bordo 2005), gained momentum in international macroeconomic policy coordination, amongst both policy-makers (the G20’s MAP being a key example) and IPE scholars (e.g. Frieden 2009; Bird 2013; Willett and Chiu 2012).

The SGP can no longer be credibly perceived as a safeguard against instability or the need to bail out other Member States (see Chapter 2). Fiscal policy coordination,



with its focus on low deficit and debt levels, did not address the structural problems in the financial sector that caused both the economic and financial crisis of 2007 and the subsequent Sovereign Debt Crisis. Wyplosz (2013) attempts to rescue the ‘sound fiscal policy’ paradigm by redefining fiscal discipline: ‘the Sovereign Debt Crisis is the result of a lack of fiscal discipline broadly defined to include adequate banking supervision’. This definition is not helpful; the attempt to bring the experience of the Sovereign Debt Crisis under the mantle of the SGP risks confounding financial regulation and public finances, that is the causality between fiscal policy outcomes and financial sector bailouts. Sound fiscal policy is hardly possible without sound financial regulation. The real threat to macroeconomic stability was found in the financial-fiscal feedback loop (Schelkle 2012), not in corybantic policy makers seeking to buy electoral favour. Critics of the post-crises reforms have been quick to point out that the reforms exclude vital elements to ensure the stability of both the eurozone and the EU economies as a whole (e.g. Katrop and Ebert 2012; Pisani-Ferry and Wolff 2012). Yet the Six Pack signals a substantial shift from a narrow surveillance of fiscal headline indicators towards broad macroeconomic surveillance.

Even prior to the crisis, fiscal policy coordination under the SGP was failing (see Chapter 1). The experience of the crisis has shown that the underlying cause for this is not because Member States refuse to accept a deficit limit that would constraint their public finances. Member States are not prepared to accept rules for fiscal stimulus policies as well. In other words, the failure covers both fiscal constraint and fiscal expansion. The SGP was created to prevent other Member States from requiring a bailout either from the ECB or from one another. It did not succeed on either account. Ultimately the Pact has not fulfilled its purpose and should be disbanded. This is neither a radical, nor a novel suggestion (e.g. Enderlein 2004). In principle, low budget deficits are desirable; countries running excessive deficits need to consolidate public finances. The problem is rather that the Pact signals a hierarchy of policy goals that is not justified. Disbanding the SGP can be done relatively straightforwardly. The MIP establishes the bridge between macroeconomic

imbalances and fiscal sustainability. In an accompanying document (European Commission 2011), the Commission emphasises that ‘the sustainability of public finances will not be assessed in the context of the MIP given that this issue is already covered by the SGP’. From an economic point of view, the artificial differentiation between macroeconomic imbalances and fiscal sustainability is impractical. In the Commission’s justification of the choice of indicators, accompanied by a comprehensive review of the literature (European Commission 2011), the link between each indicator and fiscal sustainability, default, and crisis incidences is meticulously presented (e.g. Kaminzki *et al.* 1998, Milesi-Ferretti and Razin 1996, Jorda *et al.* 2011, ECB 2010). Currently the scoreboard includes the general government sector debt in percentage of GDP, with a threshold of 60 per cent. By complementing this indicator with a (structural) deficit measure, the MIP could replace the SGP. Doing so would allow the Commission, as the guardian of the Pact to keep face and continue the work of the SGP. The European Semester recommendations already read like a more detailed and nuanced version of the EDP. Resolving the SGP into the MIP and the European Semester would uphold the idea of fiscal restraint while at the same time increasing the profile of these new processes. The Stability and Growth Pact can and should go gently into that good night.

### **Growth and Stability: the challenge of growth-friendly consolidation**

A tension between the prioritisation of and relationship between economic growth and economic stability was manifest in EU fiscal policy coordination ever since its inception. Considering the on-going challenge to consolidate both goals, the EU has come a long way. Whereas the Stability and Growth Pact was single-mindedly concerned with the achievement of low budget deficits, the economic governance landscape of 2013 strives to balance both interdependent policy goals. The recommendations for fiscal consolidation are not imposing a hard doctrine of

austerity that depicts fiscal consolidation as the harbinger of growth (see Blyth 2013). In the words of EU President Barroso (2013):

‘The Commission [...] will never propose a policy that is only based on the correction of the deficits. [...] We need to combine the indispensable, I underline indispensable, correction of the disequilibria in public finances, namely huge deficits, huge public debt, fiscal rigour, this is indispensable, we need to complement this with proper measures for growth, including short term measures for growth, because we know that some of those reforms take time to produce effect.’

The post-reform application of newly created or modified institutional tools suggests that Barroso’s statement amounts to more than the strategic appeasement of an audience weary of painful austerity measures. The post-2008 flexibility was endorsed by Ecfm Commissioner Rehn (2012): ‘contrary to the misleading impression [...] that the EU fiscal framework forces all Member States into a ‘one-size-fits-all’ consolidation straightjacket, the Stability and Growth Pact is not stupid.’ But then again, stupid or not, the current SGP is neither a suitable nor an effective tool for the coordination of fiscal policies. Secondly, the experience of the European Semester in 2012 suggests that growth concerns are present. This is already expressed in the design of the process; country-specific recommendations for each Member State are based on both the Stability and Convergence Programmes and on policy measures to boost growth and jobs (as identified in the National Reform Programmes). European Semester recommendations explicitly caution against overly drastic austerity efforts. The communication to the Czech government for example, warns that ‘swift and durable recovery is hindered in the Czech Republic by repeated cuts in public investment expenditure’ (COU 2013a); similarly the communication to the Polish government advises that ‘a low share of growth-enhancing expenditure (education, research and innovation) and declining public investments hamper long term growth prospects’ (COU 2013b).

Still the EDP and the European Semester are primarily concerned with ‘sound public finances’. The discussion of economic growth differs fundamentally from the debates on ‘growth free-riding’ during the Great Recession. The recommendations to the

Czech and Polish government illustrate this point. Crucially, both governments are not cautious about easing austerity measures to boost economic growth throughout the EU, but because specific policies work against the goal of meeting the EDP targets. In other words, concerns about economic growth (or growth-friendly consolidation, see below) are a means to an end: respecting the SGP. Note that surplus countries, or Member States who are currently not subject to an EDP, were not recommended to ease their consolidation efforts.<sup>163</sup> The public good in question is not the economic recovery of neighbouring states, or free-riding on other Member States by weakening domestic demand, but again stability as expressed by ‘sound public finances’. This logic re-imposes the hierarchy of pre-crisis goals.

Of all the new processes for macroeconomic surveillance and coordination, the Macroeconomic Imbalance Procedure has the strongest potential to address growth free-riding. The selection of cases is a matter of discretion for the European Commission. The aim of the scoreboard is to filter countries that warrant in-depth studies, in order to determine whether the potential imbalances identified in the early-warning system are benign or problematic. In its publication ‘Scoreboard for the Surveillance for Macroeconomic Imbalances’ the Commission (DG Ecf. 2012) presents a clear focus on account deficit countries:

‘In particular, unlike current account deficits, large and sustained current account surpluses do not raise the same concerns about the sustainability of external debt and financing capacities, concerns that can affect the smooth functioning of the euro area (which is a key criterion for triggering the corrective arm of the MIP). This means that surveillance under the MIP will encompass all Member States, but that a greater degree of urgency is required in countries with large current account deficits and competitiveness losses.’

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<sup>163</sup> This is essentially what is proposed by Wyplosz and Ji (2013: 38): ‘The creditor countries that have stabilized their debt ratios should stop trying to balance their budgets now that the eurozone is entering a new recession’.

This emphasis can be traced back to the Van Rompuy Task Force<sup>164</sup> report (2010) which concludes that ‘given vulnerabilities and the magnitude of the adjustment required, the need for policy action is particularly pressing in Member States showing persistently large current-account deficits and large competitiveness losses’. This means that surplus countries set the benchmark for good behaviour to be emulated by Member States running an external deficit (Heise 2011: 14). Out of the 2012 in-depth EIP countries, the Netherlands and Sweden were surplus countries. Yet this was not the reason for their selection (the cause being concerns over private sector/household debt). The evaluations state that ‘the competitiveness and export performance of the Dutch economy appears to be benign overall’ (COU 2013c) and that ‘the Swedish current account surplus is large, but it does not seem to point to an underlying imbalance in the economy’ (COU 2013d). The country selection of the 2012 EIP clearly shows that imbalances are considered ‘an asymmetrical problem’ (Schwarzer 2012: 38) which places the burden of correction on the deficit countries. Hodson (2013) characterises this as ‘a politically convenient asymmetry given the reluctance of German authorities to countenance measures that could hinder the country's external competitiveness’. Against this backdrop, the decision of the European Commission to launch an in-depth review against Germany in November 2013 came as a surprise to many. Following statistical revisions, the external surplus indicator has exceeded the threshold each year since 2007, with the surplus expected to remain above the indicative threshold over the forecast horizon. Opening an in-depth review against ‘the euro area’s unofficial leader, hub economy and chief creditor’ (*the Economist* 16.11.2013) suggests a willingness from the Commission’s side to address ‘growth-free riding’ under the MIP.

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<sup>164</sup> In March 2010, Member States, with the German Chancellor taking the lead, appointed the Council President Herman van Rompuy as the chief mediator under the Van Rompuy Task Force (VRTF), to work on a proposal to reform the existing economic governance architecture. The task force was composed of the finance ministers of the 27 Member States, thus making it a distinctly intergovernmental group. In parallel to the VRTF, the Commission was working on its own proposal.

## The Great Stability Paradigm

The MIP, though still in its infancy, has the potential to provide not only a broad review of economic policy surveillance, but also support the twin notion of free-riding. This could take place both in terms of the interpretation of the account surplus threshold as well as the modification of the scoreboard.<sup>165</sup> A provocative Economic Papers article, written by the Commission's Jan in 't Veld (2013), estimates the impact of fiscal consolidation measures undertaken in the 2011-13 in the eurozone periphery and core. In 't Veld shows that spillovers from consolidations in Germany and core eurozone have worsened the overall economic situation (see also Chapter 2). The degree of consolidation in Germany and other core countries is considered to be in contrast to the fiscal space these countries had in the crisis and 'have made adjustment in the periphery harder, and have further exacerbated the temporary worsening of the debt-to-GDP ratios in programme and vulnerable countries' (*ibid.* 15). In 't Veld's findings point to post-crisis growth free-riding (i.e. too much consolidation in the light of sufficient fiscal space) by Germany and other core countries in the aftermath of the Great Recession. According to the author, 'optimal policy coordination in the euro area would have required a differentiation of consolidation efforts depending on the fiscal space to minimise the negative spillovers' (*ibid.*). This paper, although not necessarily reflecting the Commission's views, is interesting in that it suggests a broader appreciation of fiscal free-riding behaviour within the Commission than Oli Rehn's rebuke on the negative fiscal multipliers<sup>166</sup> would suggest.

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<sup>165</sup> The Commission specifically concedes this point: "The composition of the scoreboard indicators may evolve over time" (European Commission 2011).

<sup>166</sup> In February 2013 Oli Rehn, the Commissioner of Economic and Monetary Affairs, sent a letter to EU Finance Ministers criticising a recent IMF publication that suggested that the size of fiscal multipliers was larger than previously assumed and that fiscal consolidation could worsen public finances. According to Rehn (2013) this 'debate that has not been helpful' and the Commissioner sought to swear Member States to the grim necessity of continued austerity politics.

The current state of fiscal policy coordination (that is, at the time of writing, almost exclusively the coordination of fiscal consolidation) shows that the emerging ‘Great Stability Paradigm’ is far from being universally accepted. How large should consolidation efforts be? Should surplus countries be expected to run a temporary fiscal stimulus to boost output and help reduce their current account surpluses? How much should national taxpayers pay for other EU countries in need of financial assistance? These questions remain contested among EU Member States and unless a new fiscal policy consensus can be forged, there is little reason to assume that policy ideas can serve as an Olsonian incentive, which could prevent stability or growth free-riding.

### **Market Discipline and stability free-riding**

I have argued in Chapter 6 that *de facto* market discipline constrained public finances and limited stability free-riding behaviour during the Great Recession: by and large, Member States’ fiscal crisis responses did not exceed their fiscal space. Since the eurozone Sovereign Debt Crisis erupted in 2009, market punishment has featured prominently in fiscal policy debates. How much should EU Member States, and particularly those inside the eurozone, rely on financial market participants to reign in other states’ ‘excessive’ spending and boost consolidation? How can market forces be mitigated and be made to work in favour of achieving sound fiscal policies? Market discipline, despite its obvious shortcomings, is still attractive for policy-makers who wish to outsource the politically difficult process of peer discipline (see the discussion on second-order free riding problems in Chapter 6).

Various proposals (for a review see Curzio 2011) on a common issuance of sovereign bonds, which would tame market discipline to varying degrees, were met with no success. As the Green Paper on the feasibility of introducing Stability Bonds (European Commission 2011) put it, ‘[the] more extensively credit risk would be pooled among sovereigns, the lower would be market volatility but also market

discipline on any individual sovereign'. This in turn means that 'fiscal stability would have to rely more strongly on discipline provided by political processes' (*ibid.*). Proposals of common bond issuances suggest a long-term solution to the 'too much' question of market discipline. Eurobonds set clear targets<sup>167</sup> for sovereign borrowing that should be 'punished' (via changes in risk premiums or the bond maturity structure) by financial market participants. In this respect they are comparable to the Maastricht Treaty and subsequently the Stability and Growth Pact which established, albeit temporarily, new criteria of markets' evaluation of sovereign risk (see Mosley 2004).

The challenge remains to 'find a way to channel market discipline in a positive way' (Hallerberg 2011: 129). The persisting weakness of the reformed economic governance architecture in combination with an explicit endorsement of financial market pressure, suggest that EU policy-makers are prepared, for better or worse, to continue to rely on market discipline as a means to limit stability free-riding. Despite the tremendous upheaval of the eurozone Sovereign Debt Crisis, EU policy-makers did not agree to discourage discrimination in sovereign risk pricing. On the contrary, the German Finance Minister Wolfgang Schäuble (CDU, 2012) launched into a full-hearted defence of market discipline at a EU summit:

'But we must not simply abandon interest rates as a disciplinary mechanism. Governments need the markets. Markets tell governments things that governments don't want to hear. And they force governments to do the right thing, although too often too late and too suddenly. For this reason, I am convinced that we cannot do away with the threat of higher interest rates for spendthrift states.'<sup>168</sup>

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<sup>167</sup> For instance, according to Delpa and von Weizsäcker's proposal (2010), the bond issue of every participating country would be divided into a blue bond part of up to 60 per cent of a country's GDP and a red part for the rest of its outstanding debt. Only the blue bond would be guaranteed by all members. This is thought to channel market forces to target (demand risk premiums on) red bonds. According to Schelkle's (2012) Eurobond proposal, Member States agree on the overall volume of Eurobonds to be guaranteed collectively and the share of each Member State. If a country wants to issue debt beyond the agreed quota it has to do so by borrowing at for some countries presumably higher country rates.

<sup>168</sup> Wren-Lewis (2013) goes one step further and argues in favour of market discipline formally replacing the SGP: fiscal governance can and should reside at the national level, where it can focus on both national stabilisation and the control of public debt.



## **Moderating market discipline**

Ever since the dawn of financial globalisation, policy-makers in the developing and developed world have sought to (re)define the relationship between global capital markets and government autonomy (Weiss 1998; Jessop 2002; Mosely 2005). For EMU policy-makers this challenge is complicated by the unique status of eurozone membership. In Chapter 6 I argue that the constraints of market discipline are higher inside EMU than outside. The vulnerability of EMU Member States during the European Sovereign Debt Crisis has certainly lead to an increasing awareness that EU Member States and policy-makers can and should moderate market discipline. In his foreword to the celebratory publication the EU@10, then ECFIN Commissioner Almunia (2008: 2) has already upheld the principle of market discipline while at the same time pushing for greater economic surveillance. In his words, the Commission ‘cannot rely on market discipline alone. We need to deepen and broaden macroeconomic surveillance in EMU and encourage structural reforms by integrating them into the process of policy coordination’ (*ibid.*). This view retains, and increasingly so, strong currency among EU policy-makers, both at the national and the EU level: market discipline needs to be mitigated where it is considered too strong and supplemented by macroeconomic surveillance where it is considered too weak. The approach of combining market discipline and EU rules has been favoured by the architects of EMU from the beginning of the ‘road to Maastricht’, as it was thought to addresses the problems of moral hazard and herd behaviour. The first concerns the incentives of national policy-makers and financial market participants, the second the potential irrationality of market forces. The moral hazard of bailout expectations would then alter both the behaviour of market participants and that of Member State governments. Concerning the first, the European Commission (1990: 122), for instance, was concerned that market discipline may not be sufficient ‘due to expectations of Community assistance’. This concern was already raised in the Lamfalussy report (1989), which pointed out that closer economic integration might generate expectations that a country in critical conditions would be bailed out by the

other countries. Market discipline, so the argument goes, would be weak and risk pricing would not accurately reflect a country's sovereign risk. In the absence of strong market discipline and assuming community assistance, eurozone Member States would then run higher deficits than they would if they were outside the eurozone. Besides the issue of moral hazard, the architects of EMU were also cautious about relying on market forces alone to discipline governments on the grounds that financial market participants are prone to herd behaviour (Lux 1995). The Delors Report (1989: 20) comes out clearly against enlisting market forces because instead of 'leading to a gradual adaptation of borrowing costs, market views about the creditworthiness of official borrowers tend to change abruptly and result in the closure of access to market financing'. Here, market perceptions are characterised as unreliable and erratic.<sup>169</sup>

Kuenzel and Ruscher (2013: 4) argue that 'underpinning the prevailing pre-crisis attitude of "benign neglect" towards wider macroeconomic vulnerabilities may have been a tacit belief that the main disciplining role should fall to financial markets'. This belief in the rectifying force of market discipline has been called into question by the 2008-2013 crises. Part of the problem lies in the narrow focus of the Stability and Growth Pact. By setting the deficit ceiling of 3 per cent, policy-makers influenced the criteria for fiscal sustainability used in market participants' evaluation of sovereign risk (Mosley 2004). But, again, respecting the SGP neither sufficed to ensure sound macroeconomic policies across the EU nor prevented the financial sector crises, as risks originated in much broader developments (Buti and Carnot 2012). The MIP offers a more comprehensive account of stability than the SGP. There seems to be an awareness that the MIP can evolve into the same information shortcut for markets that the Convergence Criteria did in the mid-1990s. This is

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<sup>169</sup> It appears that even during the Sovereign Debt Crisis bond yield spreads can still largely be explained on the basis of economic fundamentals during the crisis (e.g. von Hagen *et al.* 2011). What is more, despite the political discourse accusing financial markets of 'running riot' (Sarkozy 2011) and of 'speculating on the debt that was taken on to save these very institutions' (Merkel 2010), there is 'no evidence of significant speculation effects originating from CDS markets' (Arghyrou and Kontonikas 2011: 1).

evidenced by the fact that in the first round of the Excessive Imbalance Procedure, no country (not even Cyprus where a banking crisis erupted in the following year) was found to have excessive macroeconomic imbalances. The cautious wording ('very serious' instead of 'excessive') of country reports suggests a guarded approach, so as not to alert financial markets and signal credit risks.

### **The Future of Art. 125**

Lane (1993) argues that four criteria need to be fulfilled for market discipline to be effective.<sup>170</sup> First, financial markets must be free and open. Second, markets must have adequate and accurate information about the conditions which they consider indicative of sovereign risk. Thirdly, lenders will not be bailed out in the case of an impending default, and finally, borrowers are responsive to market signals before being excluded from the markets. Of these four conditions, the third one poses the biggest obstacle to effective market discipline in the future. Crucially, Lane considers this to be not only the most important reason for the failure of market discipline but also the most difficult criterion to be met. The reason for this lies in the fact that it relates to the credibility of a non-commitment. EU Member States not only have to pledge not to bail each other out (see Article 125 TFEU), but market participants must also believe that this promise will be kept.

The Sovereign Debt Crisis has shown that the no-bail-out pledges of the ECB and Member States came at a high cost. In the light of policy interdependence, the negative economic consequences of not providing financial assistance to a Member State in distress made it effectively impossible to ever really enforce the no-bailout-provisions. Chapter 2 presented policy coordination as a direct result of policy

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<sup>170</sup> The criteria of Hallerberg (2011) are similar to Lane (1993). Specifically, Hallerberg argues that markets need to have accurate information, the market valuation of a given state must be an accurate valuation of the sustainability of that state's finances (i.e. including the probability of a bailout); and populations need to interpret market discipline as an indication about their government's competence and punish governments that face market pressure. It is this punishment which would induce what Lane considers to be the fourth criterion of market discipline, namely policy-maker responsiveness.

interdependence. Of course interdependence may not only necessitate coordination, but also intervention. In recognition of the need for financial assistance, the EU and its eurozone Member States set up stabilisation mechanisms consisting of the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF). The European Stability Mechanism (ESM), which builds on the EFSF, was inaugurated in October 2012 and will be the primary support mechanism to Eurozone Member States.<sup>171</sup> Whereas the EFSF was based upon backing Member States' guarantees, the ESM has subscribed capital, providing a lending capacity of €500bn by 2014.

These mechanisms did very little to mitigate market discipline, simply because their capacity to bail out countries in distress remains questionable. First, receiving financial assistance is based on conditionality and political uncertainty. Member States seeking assistance were required to sign the 'Memorandum of Understanding' obliging programme countries to implement substantial reforms and fiscal consolidation. This austerity mix does not seem to improve sovereign risk in the short term. As IMF Chief Economist Oliver Blanchard (2012) put it, 'financial investors are schizophrenic about fiscal consolidation and growth. They react positively to news of fiscal consolidation, but then react negatively later, when consolidation leads to lower growth.' Secondly, EFSF involvement may introduce 'Private Sector Involvement' (PSI). PSI was introduced in the financial assistance package to Greece and market participants may believe that this sets a precedent for similar conditions on EFSF lending in the future. Collignon (2012:32) considers that as a result, 'promises by Member State governments are no longer credible and risk

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<sup>171</sup> Comparable Balance of Payment assistance is available to non-eurozone Member States (in limited amounts, with a maximum set by regulation).

adverse investors shy away from holding European sovereign bonds'.<sup>172</sup> Thirdly and most importantly, the funds are simply not sufficiently leveraged to support countries in need. Wyplosz (2012: 16) assumes that 'the EFSF is a sideshow that provides the ECB with an excuse not to act as lender of last resort'.<sup>173</sup> Since 2009 the ECB has taken numerous initiatives to fight liquidity problems affecting financial institutions and ensure a smooth transmission of monetary policy, notably through intervention in secondary sovereign markets. Despite these 'unconventional' measures, bond spreads were still rising. In July 2012, with feasible policy options dwindling and inadequate Member State government action, the ECB president Mario Draghi (2012a) declared that it would do 'whatever it takes to preserve the euro'. The desired effect of this announcement was almost instantaneous. In Spain, for example, the interest rate on ten-year government bonds fell from 7.62 to 6.75 per cent within a week of Draghi's promise and to 5.27 per cent by the end of 2012, with similar effects observable throughout the eurozone (Hodson 2013b). Subsequently the ECB has become the *de facto* lender of last resort with the launch of 'outright monetary transactions' (OMT) that put a backstop to the Sovereign Debt Crisis. These transactions, which allow for the purchase of government bonds in the secondary market, are essentially a financial assistance mechanism. Similar to the ESM, OMT countries are subject to strict conditionality and approval is subject to a similar procedure (with the support from the EU and the IMF needed).

In the short-run Draghi's pledge has mitigated market discipline; the No-Bail-Out Clause is no longer, if it ever was, credible. That does not however mean that market

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172 It remains to be seen how much of a surprise the 'haircut' really was and whether losses under PSI were already included in investors' models of risk pricing. Buchheit and Mita Gulati (2010) argue that the inclusion of collective action clauses (CACs), which aim at facilitating the process of restructuring outstanding bonds, would make little difference provided debt continues to be issued under national law and CACs may be difficult to implement in practice or unnecessary. Conversely Hallerberg (2011: 139) suggests that 'a real 'haircut' is necessary in this worst-case scenario to ensure that markets play some sort of disciplining role in the future'. Jens Weidemann (2011), the President of the German Bundesbank, expressed his dissatisfaction with the introduction of CACs as they did not go far enough in guaranteeing private sector involvement. He instead championed the Bundesbank's proposal to a trigger clause stipulating that maturities will be automatically extended for a fixed period of time in the event of ESM assistance for a Member State.

<sup>173</sup> A lender of last resort is the ultimate source of credit for a given country's financial system.

discipline will stop. The main reason for this lies in the fact that current bailout arrangements, whether they involve Member States or the ECB, are deeply political. Their credibility is, in other words, contingent on the political ability and willingness to assist other Member States in crisis. Bond yields for crisis countries in the periphery have not fallen uniformly and market participants continue to distinguish between Member States' credit risk (ECB 2013c). Yet given the unresolved vulnerability of the EU banking sector and the threat of contagion, it is unlikely that a Member State in distress would be denied financial assistance, irrespective of the commitment to OMT/ESM conditionality. The treatment of Greece is likely to set the tone here. In times of crisis it is simply impracticable to enforce harsh conditionality to the point where 'non-compliance' with the agreed lending conditions would lead to a break of financial assistance.<sup>174</sup> Given the persistence of the nexus of financial sector and sovereign credit risk (Acharya *et al.* 2011), financial assistance is likely to be a permanent and resilient feature of EU economic governance. This has implications for fiscal policy coordination. As one interviewee from the Commission concluded, '[fiscal policy] coordination was thought to work through peer pressure, then it became peer review, and now we reached a phase of peer support' (author interview, Spring 2011).

### **Issues for the future**

Fiscal policy coordination in the near future is not condemned to failure. Despite the lack of coordination during the Great Recession and the fact that group latency among EU Member States is likely to increase, the incentives for group-oriented behaviour are, at least in theory, strengthened. The Macroeconomic Imbalances Procedure in particular has the potential to evolve into a comprehensive review of Member States' economic policies, which could address both stability and growth free-riding. The latter is particularly relevant as the pre-crisis (2008-2010) consensus

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<sup>174</sup> This is not to suggest that past consolidation efforts were not tremendous or painful.

on the merits of stimulus spending has eroded and EU public opinion is currently divided on the right policy mix in times of sluggish economic growth and fragile financial systems (Eurobarometer 76.1). In this climate, the emerging ‘Great Stability Paradigm’ is far from universally accepted. In principle, the MIP is however well suited to help forge a new policy consensus. Pre-crises, the SGP was a predominately numerical exercise (honing in on the fiscal deficit criterion of the Maastricht Treaty) in the hope of improving compliance if fiscal policy coordination was focused on a visible and straightforward number that was not open to contestation within the Council. Conversely, the 6-Pack opens up the debate on ‘good’ macroeconomic policies and thereby creates a space for policy contestation and learning. This may make fiscal policy coordination burdensome, complex and even contradictory in the short run. In the long run there is a chance that the new practices and processes of fiscal policy coordination may result in a new strong policy consensus. Applying McNamara’s (1998) argument of the transformative power of Germany’s monetarist ideas, a new post-crises policy consensus may redefine state interests in cooperation and the group-oriented behaviour needed to sustain the interdependence reinforced by E(M)U membership.

In the meantime, the 2011 reforms have not moved beyond an incentive system that is marred by second-order free-riding problems. Despite this failure stability free-riding is unlikely to be rampant. I have argued in this thesis that during the Great Recession market discipline has deterred Member States from implementing stimulus policies that exceed their fiscal space. Although the creation of the ESM/ EFSF and the OMT backstop (with the onus on the latter) have prevented an escalation of the Sovereign Debt Crisis, pivotal further steps – notably, fiscal integration (i.e. Eurobonds) as well a financial integration (i.e. Banking Union, see Howarth and Quaglia 2013) – have escaped agreement to date. The past and current design of EMU has thus emerged as the midwife of market discipline.

In times of fiscal consolidation, financial markets offer a scapegoat for unpopular policy choices. Austerity politics are thus presented as the forced policy of a state that has become a residual authority sandwiched between financial market pressure and the conditionality of EU financial assistance. This view is echoed by De Grauwe and Ji (2013b), who argue that austerity measures in peripheral eurozone Member States ‘have been dictated too much by market sentiment instead of being the outcome of rational decision-making processes’. Consequently, fiscal consolidation is the price for restoring market confidence (Altman 2013). This narrative of the powerless state, faced with, as the French President Hollande (2012) put it, ‘the enemy [of] the world of finance’, is politically convenient. Extending Schäuble’s (2012) logic, financial markets not only ‘tell policy-makers what they don’t want to hear’, but also what other Member States cannot or do not want to enforce. Not wanting to forgo the disciplinarian effects of sovereign risk pricing, policy-makers have amplified the constraints of market discipline (de Grauwe 2011; Gros 2011) with considerable costs for national economies and the E(M)U project as a whole. This rekindling of market discipline put existing assumptions of credit risks into question – ‘old market assumptions have broken down’ (*Financial Times* 9.06.2010). Phillips (2012: 4; see also Barta 2011) suggests that the past crisis years have revealed ‘a new paradigm of financial market behaviour in developed countries’. If this is indeed the case, EU policy-makers need to reconcile the constraints of financial globalisation with their deliberate choice to enlist market forces as fiscal policy sheriff.



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## Appendices

### A1. Data Definitions and Sources

$\Delta$  BB: Change in the budget balance (Source: Ameco 2012).

$\Delta$  PB: Change in the primary budget balance (-interest payments) (Source: Ameco 2012).

$\Delta$  SB: Change in the structural budget balance (Source: Ameco 2012).

$\Delta$  PSB: Change in the primary structural balance (Source: Ameco 2012).

$\Delta$ GDP: Real GDP annual growth rate in % (Source: Ameco 2012).

$\Delta$ DEBT: Change in general government gross public debt as a share of GDP in % (Source: Ameco 2012).

BAILOUT: Direct costs (recorded as an increase in debt) of financial sector interventions in % of GDP (Source: Eurostat 2012).

AS: Size of automatic stabilisers as % of GDP. Calculated as the change in the output gap multiplied by the revenue-to-GDP ratio (used as a proxy of the semi-elasticities of the budget balance) (Source: Ameco 2012).

HERFGOV: The sum of the squared seat shares of all parties in the government. In the case of “other” parties, Herfindahl divides the number of “other” seats by the number of “other” parties and uses this average for the size of the “other” parties. Independents are calculated as if they were individual parties with one seat each. (Source: Beck *et al.* 2001).

HERFOPP: Calculated in the same manner as the Herfindahl Government. Equals NA if there is no parliament. If there are any opposition parties where seats are unknown (cell is blank), the Herfindahl is also blank (Source: Beck *et al.* 2001)

LEFT: A 0-1 dummy, coded 1 if a left government is in power. Variable is based on EXECRLC in Beck *et al.* (2001) which records the party orientation of the executive with respect to economic policy. Left: for parties that are defined as communist, socialist, social democratic, or left-wing.

ELECTION: A 0-1 dummy, coded 1 if an election was held in that year (Source: Beck *et al.* 2001).

FISRULE: Standardised Fiscal Rules Index. The fiscal rules index measures the strength of fiscal rules based on their legal basis, coverage, strictness of monitoring and enforcement, and media visibility (Source: European Commission 2012).

INTEREST: Debt servicing costs, interest expenditure as % of GDP (Source: Ameco 2012).

EU: A 0-1 dummy, coded 1 for EU membership.

EUROZONE: A 0-1 dummy, coded 1 for eurozone membership.



## A2. Figures and tables

Figure 3.1 The three-step testing design

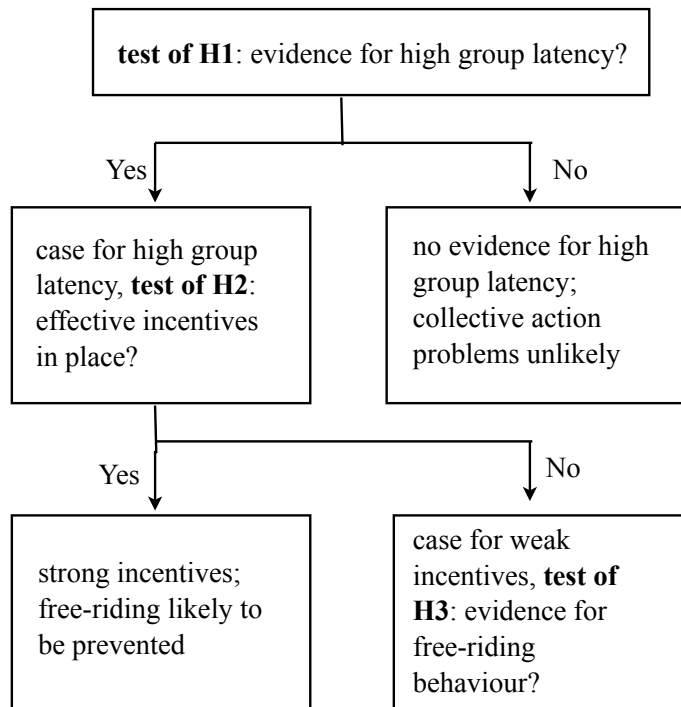


Figure 4.1. Overview of the fiscal impulse and its components, ECB (2010:23)

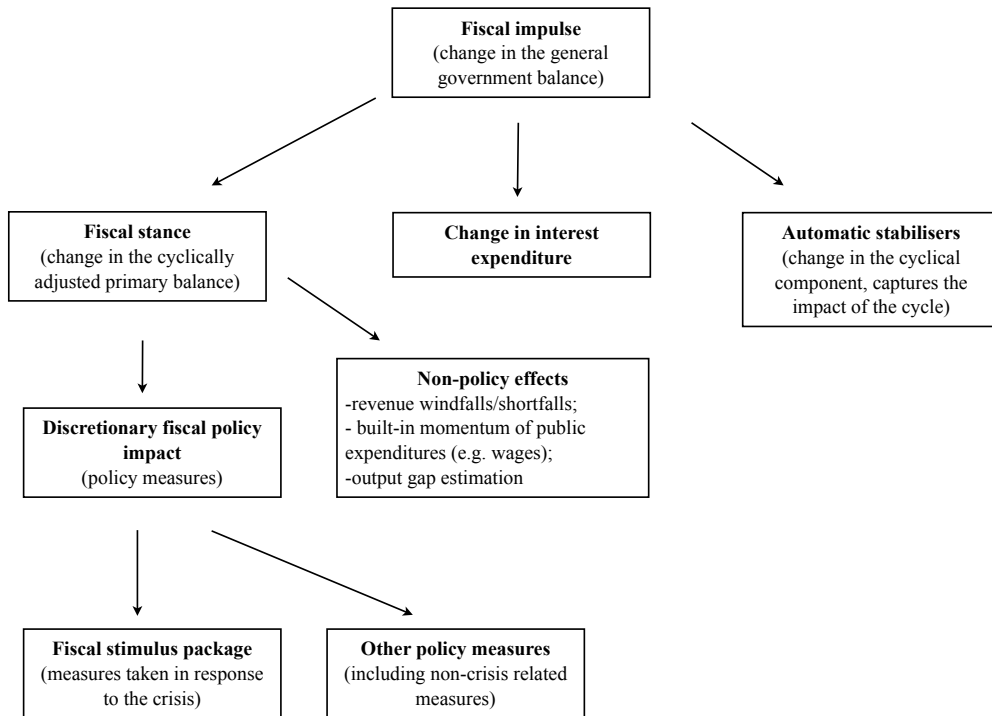
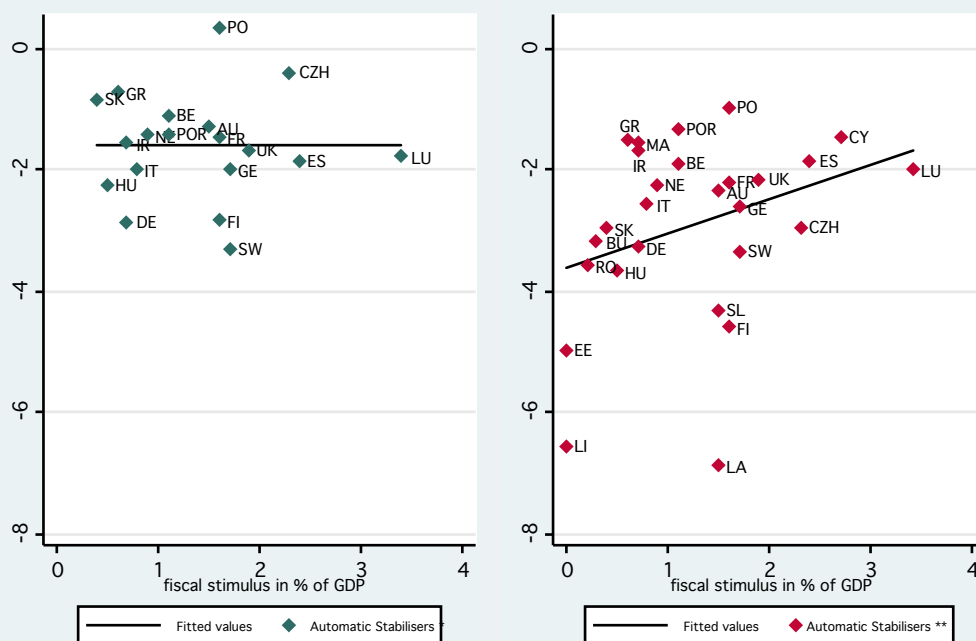


Figure 4.2 Fiscal stimulus packages and the size of automatic stabilisers (in % of GDP) in 2009



\* based on Girouard and André (2005), \*\* based on European Commission (2010)

Table 4.1 Fiscal stimulus figures in comparison

	COM <sup>a</sup>	OECD <sup>b</sup>		ECB <sup>c</sup>	ILO <sup>d</sup>	Saha &Weiz <sup>e</sup>	IMF <sup>f</sup>	Watt <sup>g</sup>
Country	total	total	total	total	2009	2009	total	total
BE	2.2	1.6	1.4	0.8	0.5	0.4		0.9
CZ	3.5	3	2.8					
DK	2.2	2.5	3.3			0		2.2
DE	4.1	3	3.2	2.3	2.8	1.5	3.6 (3.9)	2.64
IE	1.7	4.4	8.3	1		0		
EL	0.6		0.8	0		0		
ES	3.2	3.5	3.9	2.9	0.8	1.1		4.6
FR	3	0.6	0.7	1.1	1.1	0.9	1.5 (2.3)	1
IT	1.6	0	0	0	0.3	0	0.3 (0)	0.2
CY	5.1			0.1				
LU	5.6	3.6	3.9	2.6				1.75*
HU	2.6	4.4	7.7		3.8			
MT	1.8			3.2				
NL	1.9	1.5	2.5	1.9	0.8	1		1
AT	3.3	1.1	1.2	3.6		1.4		2.4
PL	4.8	1	1.2			0.5		
PT	1.7	0.8	0.8	1	1.1			1.2 *
SI	3.3			1.1				
SK	0.9	1.1	1.3	0.1				
FI	4.3	3.1	3.2	3.4				1.5
SE	4.4	2.8	3.3			1.3		2.4
UK	2.4	1.4	1.9		1.3	1.4	1.5 (1.6)	1.5

Note: a) *Public Finance in EMU* (European Commission 2011), Discretionary stimulus in % of GDP, b) Composition of fiscal packages Total over 2008-2010 period as % of GDP in 2008, first estimation published 03/09, second estimation published 07/09, c) fiscal stimulus package, % of GDP, ECB (2010) d) fiscal stimulus package, % of GDP, ILO (2009) e) fiscal stimulus package, % of GDP, Saha and Weizäcker (2009) f) discretionary measures, in per cent of GDP, relative to 2007 baseline (revision made in the Fiscal Monitor Nov 2010, g) Watt (2010),\* 2009 only.

Table 4.2 Financial bailout and fiscal policy, 2008-2010

	costs	contingent liabilities	liabilities	N
Fiscal stimulus <sup>a</sup>	.06	.07	.03	54
ΔBB	-.29 ***	-0.08	- .22 **	81
ΔPB	.48 ***	-.36 ***	-.30 ***	81
ΔSB	.59 ***	-.36 ***	-.36 ***	81
ΔPSB	.55 ***	-.33 ***	-.34 ***	81

Note: Correlation coefficients for EU27. Source: Eurostat (2012), AMECO database, \* Significant at the 5 % level; \*\* at the 1 % level; \*\*\* at the .1% level. <sup>a</sup> Stimulus estimates from the Commission (European Commission 2011)

Table 4.3 Non-compliance with the EERP's 1.2 % of GDP stimulus threshold

COM (2011)	ECB (2010)	OECD (2009)
<b>Greece</b>	<b>Greece</b>	<b>Greece</b>
<b>Romania</b>	<b>Slovakia</b>	<b>France</b>
<b>Slovakia</b>	Slovenia	<b>Italy</b>
<b>Lithuania</b>	<b>Portugal</b>	<b>Portugal</b>
	Cyprus	<b>Ireland</b>
	<b>Italy</b>	
	<b>France</b>	
	<b>Ireland</b>	
	<b>Belgium</b>	

Source: European Commission (2011) *Public Finances in EMU*, ECB (2010) *Euro Area Fiscal Policies and the Crisis*, OECD (2009) *World Economic Outlook*. Note: ECB estimations do only include eurozone Member States (as of 2010). OECD estimations are not available for Bulgaria, Estonia, Cyprus, Latvia, Lithuania, Malta, Romania and Slovenia. Non-compliers in bolt.

Table 5.1 Selected summary statistics

Variable	Mean	Std. Dev.	Min.	Max.
$\Delta$ PSB	-0.94	2.88	-15.07	7.21
$\Delta$ SB	-1.00	2.89	-16.21	6.43
$\Delta$ PB	-1.97	3.23	-15.79	5.55
$\Delta$ BB	0.10	5.48	-7.40	15.70
L. $\Delta$ GDP	0.18	5.44	-17.70	10.50
L. Debt	48.97	28.87	3.70	129.70
Bailout	-0.36	2.27	-20.16	0.43
L. AS	-1.16	2.01	-8.15	2.20
Herfgov	0.61	0.26	0.22	1.00
Herfopp	0.51	0.19	0.22	1.00
Left	0.30	0.46	0.00	1.00
Election	0.25	0.43	0	1
Yrcurnt	1.80	1.32	0.00	4
Majelec	0.14	0.25	0.00	0.73

Notes: Based on cross-sectional data available for all 27 EU countries over the 2008-2010 period.  $\Delta$  is the first difference operator. N= 81.

Table 5.2 Determinants of fiscal policy changes in the EU, 2008-2010

	$\Delta$ PSB		$\Delta$ SB		$\Delta$ PB		$\Delta$ BB	
L. $\Delta$ GDP	-0.23 ***	0.07	-0.24 ***	0.07	-0.17 *	0.07	-0.16 *	0.07
L. Debt	0.20 ***	0.05	0.18 ***	0.05	0.16 ***	0.04	0.39 ***	0.06
Bailout	0.91 ***	0.09	0.90 ***	0.08	0.83 ***	0.08	-0.14	0.12
L. AS	-0.98 ***	0.19	-0.93 ***	0.19	-0.13	0.26	-0.80 **	0.26
Herfgov	-21.76 **	7.51	-25.40 **	7.72	-22.27 **	6.21	-32.56 **	10.75
Herfopp	18.98 **	6.56	20.98 **	6.56	15.37 **	5.94	23.00 **	10.04
Left	3.43 ***	0.94	3.47 ***	0.94	2.77 ***	0.82	5.90 ***	1.07
Election	-1.09 ***	0.39	-1.02 **	0.38	-0.99 **	0.37	-1.07 *	0.49
Constant	-14.30 *	6.59	-9.68	7.30	-13.38 *	6.37	-39.87 ***	9.72
N	81		81		81		81	
R2	0.78		0.80		0.83		0.91	
Wald chi2	1260.85 ***		2025.72 ***		985.84 ***		1145.46 ***	

Standard errors are corrected for groupwise heteroskedasticity and contemporaneous correlation across countries of the error terms are corrected with panel-corrected standard errors. \* Significant at the 5 % level; \*\* at the 1 % level; \*\*\* at the .1 % level. Standard errors listed besides coefficients.

Table 5.3 Macroeconomic determinants of fiscal policy changes in the EU, 2008-2010

	$\Delta$ PSB		$\Delta$ SB		$\Delta$ PB		$\Delta$ BB	
	1)		2)		3)		4)	
L. $\Delta$ GDP	-0.08	0.09	-0.10	0.08	-0.13	0.07	-0.05	0.08
					*			
L. Debt	0.16	0.07	0.14	0.07	0.17	0.05	0.37	0.07
	*		*		**		***	
Bailout	0.87	0.10	0.88	0.09	0.88	0.09	-0.14	0.13
	***		***		***			
Constant	-14.48	6.29	-13.05	5.95	-15.10	4.77	-33.15	6.32
	*		*		***		**	
N	81		81		81		81	
R2	0.60		0.64		0.80		0.87	
Wald chi2	717.25	***	1,029.00	***	486.26	***	757.59	***

Standard errors are corrected for groupwise heteroskedasticity and contemporaneous correlation across countries of the error terms are corrected with panel-corrected standard errors. \* Significant at the 5 % level; \*\* at the 1 % level; \*\*\* at the .1 % level. Standard errors listed besides coefficients.



Table 5.4 Determinants of fiscal policy changes in the EU, 1999-2007

	$\Delta$ PSB		$\Delta$ SB		$\Delta$ PB		$\Delta$ BB	
L. $\Delta$ GDP	-0.07		-0.06		-0.01		-0.00	
	0.06		0.06		0.06		0.06	
L.Debt	0.06	**	0.07	***	0.04		0.04	*
	0.02		0.02		0.02		0.02	
L.AS	-0.76	**	-0.71	**	0.18		0.26	
	0.24		0.24		0.24		0.23	
Herfgov	-1.06		-1.24		-0.62		-0.98	
	1.15		1.11		1.05		1.04	
Herfopp	1.24		0.61		0.84		0.02	
	1.19		1.16		1.08		1.07	
Left	0.50		0.44		0.51	*	0.39	
	0.27		0.26		0.24		0.24	
Election	-0.82	***	-0.90	***	-0.82	***	-0.85	***
	0.22		0.21		0.22		0.22	
Constant	-5.28		-4.88		-1.85		-1.54	
	3.37		3.16		3.05		2.98	
N	181		181		181		182	
R2	0.33		0.33		0.45		0.41	
Wald chi2	99.41	***	116.21	***	153.71	***	141.10	***

Standard errors are corrected for groupwise heteroskedasticity and contemporaneous correlation across countries of the error terms are corrected with panel-corrected standard errors. \* Significant at the 5 % level; \*\* at the 1 % level; \*\*\* at the .1 % level. Standard errors listed below coefficients.

Table 6.1 Selected summary statistics

Variable	Observations	Mean	Std. Dev.	Min.	Max.
Fisrule	81	0.455	0.967	-1.12	2.46
Interest	81	2.184	1.28	0.13	5.95

Notes: Based on cross-sectional data available for all 27 EU countries over the 2008-2010 period.

Figure 6.1 A stylised model of market discipline (adapted from Mosley 2000)

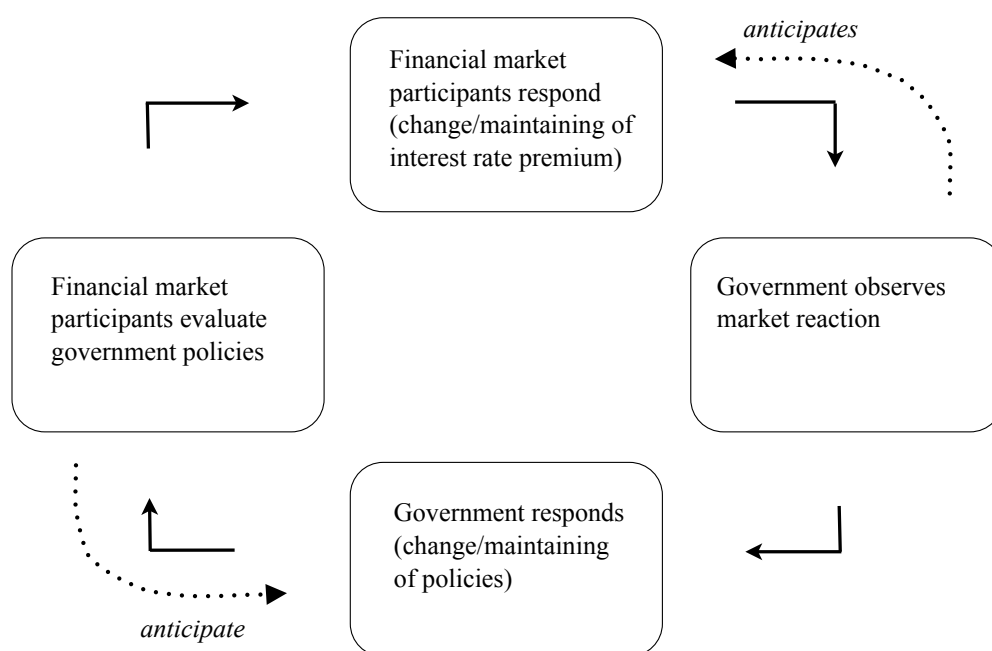


Table 6.2 The impact of fiscal rules, 2008-2010

	$\Delta$ PSB		$\Delta$ SB		$\Delta$ BB		$\Delta$ PB	
	1)		2)		3)		4)	
L. $\Delta$ GDP	-0.20	*	-0.22	**	-0.10		-0.17	*
	0.08		0.08		0.09		0.08	
L. Debt	0.20	***	0.18	***	0.38	***	0.19	***
	0.05		0.05		0.06		0.05	
Bailout	0.88	***	0.88	***	-0.14		0.86	***
	0.09		0.09		0.10		0.09	
L. AS	-1.03	***	-0.97	***	-0.82	**	-0.15	
	0.21		0.21		0.27		0.21	
Herfgov	-24.50	**	-27.47	**	-37.21	***	-20.27	**
	8.21		8.39		10.91		7.61	
Herfopp	21.85	**	23.22	**	28.66	**	16.66	*
	7.26		7.42		10.00		6.92	
Left	3.60	***	3.58	***	5.21	***	2.94	**
	1.07		1.06		1.10		1.02	
Election	-1.02	**	-0.95	*	-0.43		-0.99	**
	0.39		0.38		0.49		0.38	
Fisrule	0.04		-0.00		-0.13		0.11	
	0.33		0.32		0.37		0.33	
Constant	-11.77		-7.66		-34.95	***	-12.41	
	7.51		7.31		10.02		7.46	
N	80		80		80		80	
R2	0.79		0.80		0.92		0.83	
Wald chi2	506.55	***	637.39	***	2500.00	***	652.77	***

Standard errors are corrected for groupwise heteroskedasticity and contemporaneous correlation across countries of the error terms are corrected with panel-corrected standard errors. \* Significant at the 5 % level; \*\* at the 1 % level; \*\*\* at the .1 % level. Standard errors listed below coefficients.

Table 6.3 The impact of EU membership on fiscal crisis responses

	$\Delta$ PSB	$\Delta$ SB	$\Delta$ BB	$\Delta$ PB
	1)	2)	3)	4)
L. $\Delta$ GDP	-0.13	-0.17 *	-0.18 *	-0.14
	0.08	0.08	0.08	0.09
L.Debt	0.02	0.04	0.05 ***	0.18 ***
	0.01	0.03	0.01	0.13
Herfopp	3.89	7.40	17.17 **	8.51 ***
	4.54	9.77	5.29	15.05
Herfgov	-4.92	-14.55	-27.84 ***	-14.50
	6.47	14.57	7.42	14.42
Left	3.39 **	3.69	4.54 *	4.07 **
	1.13	2.52	1.20	2.57
Election	-1.39 **	-0.33	-0.78	-0.29 *
	0.43	0.78	0.55	0.67
<b>EU</b>	<b>1.17</b>	<b>-1.93</b>	<b>-2.95</b>	<b>-5.90</b>
	<b>2.05</b>	<b>5.89</b>	<b>1.82</b>	<b>5.58</b>
Constant	-2.92	-0.63	0.60	-8.39 **
	2.11	7.63	1.94	8.00
N	93	93	93	93
R2	0.507	0.326	0.814	0.520
Wald chi2	115.215 ***	66.297 **	472.626 ***	101.786 ***

Standard errors are corrected for groupwise heteroskedasticity and contemporaneous correlation across countries of the error terms are corrected with panel-corrected standard errors. \* Significant at the 5 % level; \*\* at the 1 % level; \*\*\* at the .1 % level. Standard errors listed below coefficients.

Table 6.4 The impact of Market Discipline, 2008-2010

	$\Delta$ PSB		$\Delta$ SB		$\Delta$ BB		$\Delta$ PB	
	1)		2)		3)		4)	
L. $\Delta$ GDP	-0.17	*	-0.20	**	-0.07		-0.11	*
	0.07		0.07		0.08		0.07	
L. Debt	0.11	*	0.12	*	0.29	***	0.10	
	0.06		0.06		0.06		0.06	
Bailout	0.97	***	0.94	***	-0.05		0.93	***
	0.08		0.08		0.10		0.09	
L. AS	-0.80	***	-0.80	***	-0.54		0.03	
	0.22		0.22		0.29		0.23	
Herfgov	-29.88	***	-31.05	***	-42.03	***	-25.99	***
	8.32		8.41		11.90		7.51	
Herfopp	25.29	***	25.37	***	30.60	**	20.93	**
	7.22		7.28		10.83		6.74	
Left	3.34	**	3.41	***	5.10	***	2.69	**
	1.04		1.01		1.00		0.96	
Election	-0.96	**	-0.93	**	-0.48	***	-0.88	*
	0.36		0.36		0.46		0.35	
<b>Interest</b>	<b>2.67</b>	<b>***</b>	<b>1.86</b>	<b>*</b>	<b>2.66</b>	<b>**</b>	<b>2.36</b>	<b>**</b>
	<b>0.77</b>		<b>0.73</b>		<b>0.96</b>		<b>0.78</b>	
Constant	-12.00	***	-8.08	*	-36.01	**	-11.39	**
	7.08		7.10		9.48		7.23	
N	81		81		81		81	
R2	0.81		0.82		0.92		0.85	
Wald chi2	743.26	***	888.05	***	1900.00	***	852.25	***

Standard errors are corrected for groupwise heteroskedasticity and contemporaneous correlation across countries of the error terms are corrected with panel-corrected standard errors. \* Significant at the 5 % level; \*\* at the 1 % level; \*\*\* at the .1 % level.

Table 6.5 Market discipline and eurozone membership

	$\Delta$ PSB	$\Delta$ SB	$\Delta$ BB	$\Delta$ PB
	1)	2)	3)	4)
L. $\Delta$ GDP	-0.17 *	-0.21 **	-0.07	-0.12
L.Debt	0.13 *	0.14 *	0.31 ***	0.12 *
Bailout	1.03 ***	1.00 ***	0.02	0.99 ***
L.AS	-0.82 ***	-0.82 ***	-0.53	0.00
Herfopp	22.64 **	22.73 **	28.54 *	18.14 **
Herfgov	-26.27 **	-27.46 **	-39.10 **	-22.18 **
Left	2.39	2.47	4.29 **	1.70
Election	-0.88 **	-0.85 *	-0.43	-0.7875 *
<b>Interest_noneuro</b>	<b>2.57 ***</b>	<b>1.76 *</b>	<b>2.65**</b>	<b>2.25 **</b>
<b>Interest_euro</b>	<b>3.28 ***</b>	<b>2.46 **</b>	<b>3.27**</b>	<b>2.99 **</b>
Constant	-14.87	-10.94	-38.21 ***	-14.42
N	81	81	81	81
R2	0.82	0.82	0.92	0.85
Wald chi2	111.33 ***	1450.26 ***	1131.28 ***	1692.25 ***

Standard errors are corrected for groupwise heteroskedasticity and contemporaneous correlation across countries of the error terms are corrected with panel-corrected standard errors. \* Significant at the 5 % level; \*\* at the 1 % level; \*\*\* at the .1 % level.

Table 7.1 Fuzzy set scores and bestfit

Country	C	T	P	D	bestfit
BE	0.246	0.567	0.714	0	TPd
BU	0.443	0.133	0.179	0	tpd
CZH	0.820	0.700	0.393	0	Tpd
DE	0.541	0.800	0.536	0	TPd
GE	0.738	0.733	0.929	0	TPd
EE	0.410	0.867	0.036	0	Tpd
IR	0.295	0.967	0.429	1	TpD
GR	0.000	0.100	0.571	1	tPD
ES	0.672	0.233	0.786	1	tPD
FR	0.361	0.267	0.893	0	tPd
IT	0.000	0.300	0.821	1	tPD
CY	0.164	0.200	0.071	0	tpd
LA	0.475	0.400	0.107	0	tpd
LI	0.000	0.633	0.143	1	TpD
LU	0.623	1.000	0.250	0	Tpd
HU	0.623	0.833	0.321	1	TpD
MA	0.705	0.600	0.000	0	Tpd
NE	0.508	0.933	0.750	0	TPd
AU	0.869	0.767	0.607	0	TPd
PO	0.967	0.367	0.679	0	tPd
POR	0.295	0.167	0.464	1	tpD
RO	0.213	0.200	0.357	1	tpD
SL	0.361	0.433	0.214	0	tpd
SK	0.164	0.500	0.286	0	tpd
FI	0.770	0.667	0.500	0	Tpd
SW	0.902	0.900	0.643	0	TPd
UK	0.574	0.333	0.857	0	tPd

Note: C= compliance, T = trade openness, P = political/economic power, D= economic distress, see text for a description of the variables.

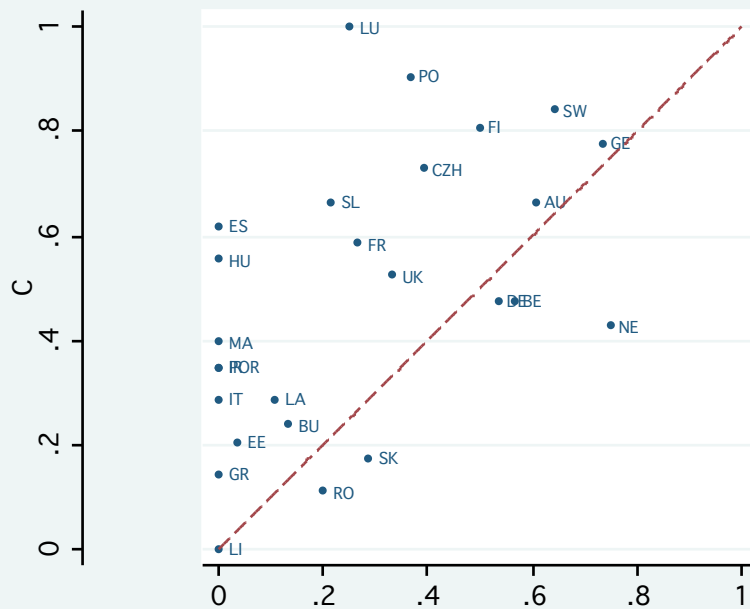


Figure 7.1 Sufficient conditions for compliance outcome  
 • TPd — y

Figure 7.2 Relationship between the size of total stimulus package and trade openness

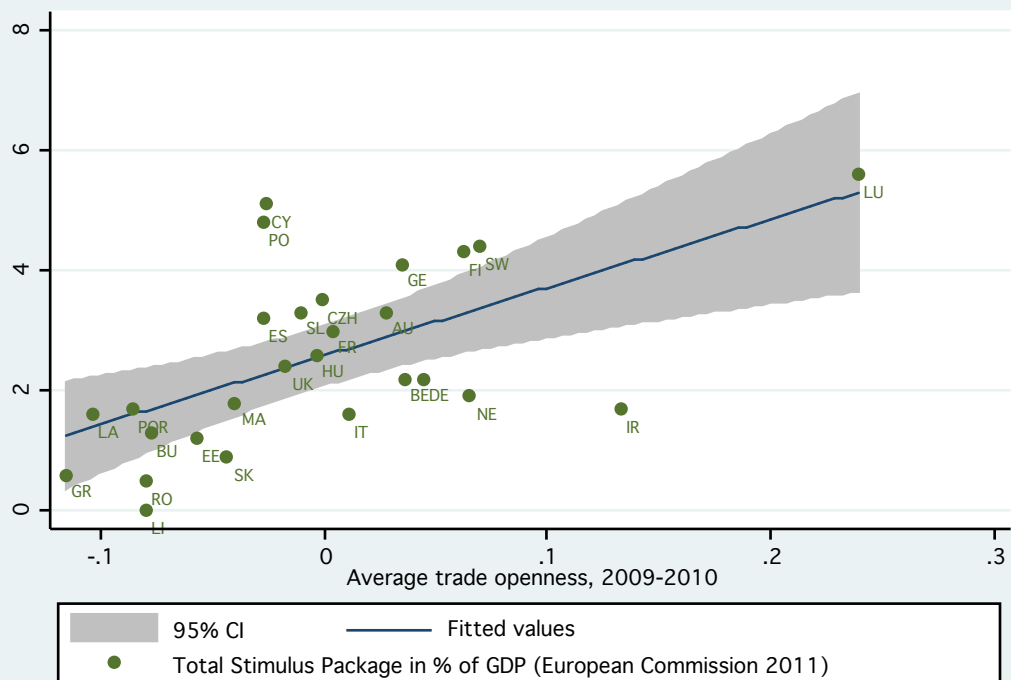
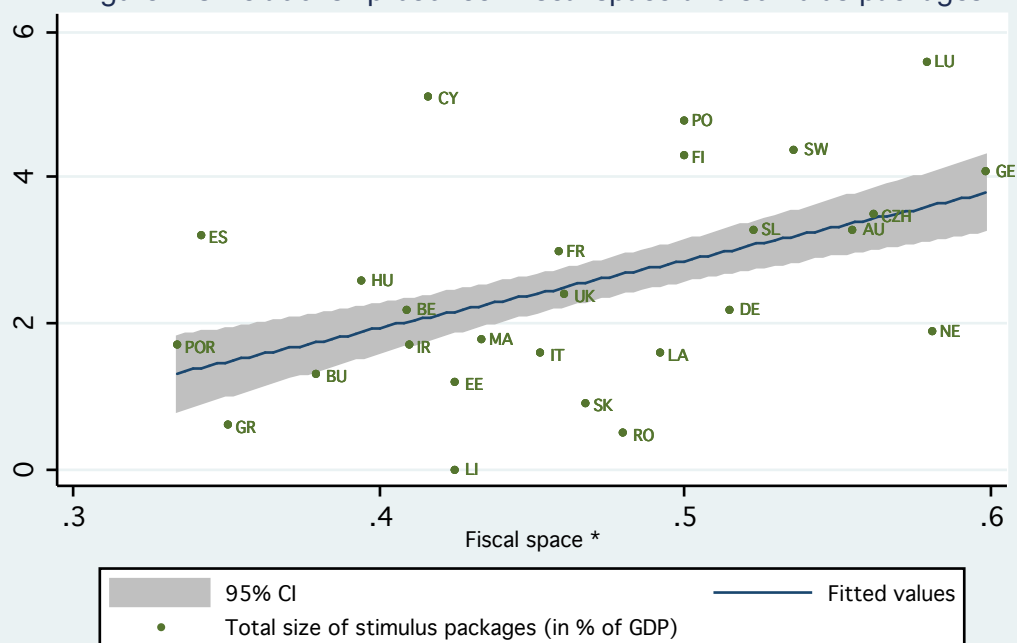




Figure 7.3 Relationship between fiscal space and stimulus packages\*\*



\* average fiscal space (2007-2010) see text; \*\* based on European Commission (2011)

### A3. Supplementary tables

Table A5.1 Determinants of fiscal policy changes in the EU with lagged dependent variable

	$\Delta$ PSB	$\Delta$ SB	$\Delta$ BB	$\Delta$ PB
L. $\Delta$ PSB	-0.35*			
L. $\Delta$ SB		-0.34*		
L. $\Delta$ BB			-0.42 *	
L. $\Delta$ PB				-0.32
L. $\Delta$ GDP	-0.33***	-0.33***	-0.14	-0.18 **
L.Debt	0.20***	0.18 ***	0.37 ***	0.18 ***
Bailout	0.86***	0.86 ***	-0.20	0.83 ***
L.AS	-0.89***	-0.83 ***	-0.63 *	-0.09
Herfopp	13.79*	15.93 *	17.25	10.91
Herfgov	-15.80	-19.77 *	-27.75 *	-14.14 *
Left	2.52*	2.59 *	4.05 **	2.04 *
Election	-1.14**	-1.07 **	-0.65	-1.02 **
Constant	-14.03	-9.49	-34.87 **	-12.81
N	81	81	81	81
R2	0.81	0.83	0.91	0.85
Wald chi2	791.05 ***	1253.92 ***	985.43 ***	990.45 ***

Standard errors are corrected for groupwise heteroskedasticity and contemporaneous correlation across countries of the error terms are corrected with panel-corrected standard errors. \* Significant at the 5 % level; \*\* at the 1 % level; \*\*\* at the .1 % level.

Table A5.2 Hausman test for endogeneity of various variables (p-values)

Variables	$\Delta$ PSB	$\Delta$ SB	$\Delta$ BB	$\Delta$ PB
Endogeneity of macro-economic variables <sup>a</sup>	0.07 **	0.05 **	0.11	0.07 *
Endogeneity of elections <sup>b</sup>	0.55	0.45	0.72	0.18
Endogeneity of fiscal rules <sup>c</sup>	0.34	0.57	0.39	0.17
Endogeneity of market discipline <sup>d</sup>	0.98	0.14	0.74	0.30

Note: The H0 hypothesis of the Hausman test is that the coefficient estimates of the standard regression model and the instrumental variables model are both consistent and do not differ. Therefore if we fail to reject H0 endogeneity is thought not to be a problem. <sup>a</sup> The two macro-economic variables GDP growth and the change in the public debt are instrumented using the lags of these variables as well as US GDP growth and public debt. <sup>b</sup> Election years are instrumented using the constitutionally determined term duration. <sup>c</sup> Fiscal rules are instrumented using the lagged variable. <sup>d</sup> Market discipline is instrumented using the lagged variable as well as US interest payments on debt.

Table A5.3 Keynesianism and fiscal policy responses, 2008-2010

	$\Delta$ PSB	$\Delta$ SB	$\Delta$ PB	$\Delta$ BB
L. $\Delta$ GDP	-0.44 ***	-0.45 ***	-0.38 **	-0.33 *
L.Debt	0.18 **	0.15 **	0.17 **	0.38 ***
Bailout	0.89 ***	0.88 ***	0.87 ***	-0.10
L.AS	-1.53 ***	-1.48 ***	-0.54	-1.52 ***
Herfgov	-32.86 *	-33.98 *	-34.83 *	-45.29 **
Herfopp	18.29 *	19.85 *	16.13	24.84 *
Rile	0.01	-0.01	0.02	0.01
Keynes	1.30 **	1.16 **	1.46 ***	1.71 ***
Election	-1.05 *	-0.94 *	-1.09 *	-0.58
Constant	-7.35	-4.01	-5.80	-33.80 **
N	64	64	64	64
R2	0.81	0.84	0.85	0.92
Wald	575.49	754.34	539.60	5400.12

Standard errors are corrected for groupwise heteroskedasticity and contemporaneous correlation across countries of the error terms are corrected with panel-corrected standard errors. \* Significant at the 5 % level; \*\* at the 1 % level; \*\*\* at the .1 % level.

Table A6.1 Descriptive statistics of key variables for Non-EU countries \* (2008-2010)

Variable	Observations	Mean	Std. Dev.	Min.	Max.
$\Delta$ PSB	18	-1.47	2.49	-8.1	2.2
$\Delta$ SB	18	-1.44	5.82	-21.4	10
$\Delta$ PB	18	-1.99	3.33	-8.16	3.8
$\Delta$ BB	18	-2.33	3.55	-8.2	2.5
L. $\Delta$ GDP	18	0.01	3.41	-6.6	6
L.Debt	18	91.29	56.51	28.49	210.25
Herfgov	18	0.71	0.28	0.26	1
Herfopp	18	0.54	0.25	0.33	1
Left	18	0.28	0.46	0	1
Election	18	0.39	0.5	0	1

\* Norway, Canada, USA, Iceland, Japan and Switzerland.

Table A6.2 The impact of fiscal rules prior to the Great Recession, 1999-2007

	$\Delta$ PSB	$\Delta$ SB	$\Delta$ BB	$\Delta$ PB
L. $\Delta$ GDP	-0.10	-0.10	-0.05	-0.05
L.Debt	0.05 **	0.06 ***	0.04 **	0.05 *
L.AS	-0.05	-0.06	1.04 ***	1.02 ***
Herfgov	-0.01	-0.37	0.28	1.00
Herfopp	1.10	0.22	0.11	1.50
Left	0.21	0.25	0.17	0.05
Election	-0.83 ***	-0.9 ***	-0.83 ***	-0.85 ***
<b>Fisru</b>	<b>0.62 *</b>	<b>0.44</b>	<b>0.71 *</b>	<b>1.26 ***</b>
Constant	-4.93	-4.98	-2.81	-4.33
N	181	181	182	178
R2	0.19	0.21	0.30	0.30
Wald	55.16 **	61.01 ***	97.87 ***	94.07 ***

Standard errors are corrected for groupwise heteroskedasticity and contemporaneous correlation across countries of the error terms are corrected with panel-corrected standard errors. \* Significant at the 5 % level; \*\* at the 1 % level; \*\*\* at the .1 % level.

Table A6.3 The impact of eurozone membership on fiscal crisis responses

	$\Delta$ PSB	$\Delta$ SB	$\Delta$ BB	$\Delta$ PB
L. $\Delta$ GDP	-0.13	-0.17 *	-0.18 *	-0.14
L. Debt	0.02	0.04	0.04 ***	0.15
Herfopp	5.71	6.53	14.50 **	0.08
Herfgov	-8.14	-12.87	-23.47 ***	0.34
Left	3.56 **	3.71	4.41 ***	3.15
Election	-1.37 **	-0.37	-0.83	-0.32
<b>Eurozone</b>	<b>-0.05</b>	<b>-1.18</b>	<b>-1.49</b>	<b>-0.94</b>
Constant	-1.96	-1.30	-0.77	-12.07
N	93	93	93	93
R2	0.51	0.33	0.81	0.51
Wald chi2	107.26 ***	73.12 ***	486.21 ***	98.15 ***

Standard errors are corrected for groupwise heteroskedasticity and contemporaneous correlation across countries of the error terms are corrected with panel-corrected standard errors. \* Significant at the 5 % level; \*\* at the 1 % level; \*\*\* at the .1 % level.

Table A6.4 The impact of eurozone membership on fiscal crisis responses, EU27

	$\Delta$ PSB	$\Delta$ SB	$\Delta$ BB	$\Delta$ PB
L. $\Delta$ GDP	-0.23 ***	-0.24 ***	-0.15 *	-0.17 *
L.Debt	0.21 ***	0.19 ***	0.40 ***	0.19 **
Bailout	0.91 ***	0.9 ***	-0.09	0.88 ***
L.AS	-0.98 ***	-0.93 ***	-0.78 **	-0.13
Herfopp	18.65 **	20.61 **	23.59 *	14.84 *
Herfgov	-21.16 *	-24.74* *	-31.41 **	-17.87 *
Left	3.31 **	3.35 **	4.68 ***	2.59 *
Election	-1.09 **	-1.02 **	-0.63	-0.99 **
<b>Eurozone</b>	<b>0.32</b>	<b>0.35</b>	<b>0.80</b>	<b>0.50</b>
Constant	-14.76	-10.19	-40.47 ***	-14.15
	-----	-----	-----	-----
N	81.00	81.00	81.00	81.00
R2	0.79	0.81	0.92	0.83
Wald chi2	539.698 ***	701.697 ***	2000 ***	664.988 ***

Standard errors are corrected for groupwise heteroskedasticity and contemporaneous correlation across countries of the error terms are corrected with panel-corrected standard errors. \* Significant at the 5 % level; \*\* at the 1 % level; \*\*\* at the .1 % level.

Table. A7.1 Weights for the EIP indicators based on factor analysis

	Factor loading			Squared factor loading*			Weight**
	F1	F2	F3	F1	F2	F3	
Current account balance	0.61	0.46	0.19	<b>0.13</b>	0.11	0.02	<b>0.09</b>
Investment position	0.55	0.24	0.52	0.10	0.03	<b>0.16</b>	<b>0.06</b>
Export market shares	-0.68	-0.25	0.43	<b>0.16</b>	0.03	0.11	<b>0.1</b>
Nominal unit labour cost	0.15	-0.84	0.03	0.01	<b>0.36</b>	0.00	<b>0.16</b>
Real effective exchange rates	-0.66	-0.31	0.32	<b>0.15</b>	0.05	0.06	<b>0.1</b>
Private sector debt	0.69	-0.39	0.08	<b>0.17</b>	0.08	0.01	<b>0.1</b>
Private sector credit flow	0.38	-0.1	0.61	0.05	0.01	<b>0.21</b>	<b>0.07</b>
Changes in house prices	-0.22	0.67	0.49	0.02	<b>0.23</b>	0.14	<b>0.1</b>
General government debt	0.32	0.19	-0.69	0.04	0.02	<b>0.27</b>	<b>0.1</b>
Unemployment rate	-0.69	0.4	-0.2	<b>0.17</b>	0.08	0.02	<b>0.1</b>
<i>Explained Variance</i>	2.84	1.94	1.73				
<i>Explained Variance/Total</i>	0.44	0.30	0.26				

Note: \* Scaled to unity sum. \*\* Final weights rescaled to sum up to one. Explained Variance is the variance explained by the factor. Explained Variance/Total is the explained variance divided by the total variance of the four factors. Weights are squared factor loadings multiplied by the Explained Variance/Total.